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No. 04-

IN THE

Supreme Court of the United States

R.J. FITZGERALD & CO., INC., RAYMOND FITZGERALD, AND LEIZA FITZGERALD,

Petitioners,

v.

COMMODITY FUTURES TRADING COMMISSION,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether objective recklessness, defined as an extreme departure from standards of ordinary care, satisfies the scienter requirement for commodities and securities fraud established by *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), such that a trial court's findings of good faith and lack of subjective intent to defraud are irrelevant.

2. Whether commercial speech held not misleading by a trial court can be deemed misleading as a matter of law on the basis of an appellate court's conclusions that the speech would be "on balance" misleading to an objectively reasonable listener or that the speech omitted information that, while not necessary to counter any specific representation to the contrary, the appellate court believes "a reasonable investor *surely* would want to know."

PARTIES TO THE PROCEEDINGS

The parties to the proceedings in the court of appeals included R.J. Fitzgerald & Co., Inc., Raymond Fitzgerald, Leiza Fitzgerald, Greg Burnett, Chuck Kowalski, and the Commodity Futures Trading Commission. R.J. Fitzgerald & Co., Inc., now defunct, was wholly owned by Raymond Fitzgerald and had no parent or related corporate entities. The decision below affirmed the trial court's judgment in favor of Greg Burnett and Chuck Kowalski. As prevailing parties below, they do not have an interest in the outcome of this petition.

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PETITION FOR A WRIT OF CERTIORARI

R.J. Fitzgerald & Co., Inc., Raymond Fitzgerald, and Leiza Fitzgerald respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eleventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 3a-44a) is reported at 310 F.3d 1321. The opinion of the district court (Pet. App. 45a-76a) is reported at 173 F. Supp. 2d 1295. The district court's judgment on partial findings at the close of the CFTC's case-in-chief (Pet. App. 77a-86a) is unreported.

JURISDICTION

The district court had original jurisdiction under the Commodities Exchange Act, 7 U.S.C. § 13a-1, and 28 U.S.C. § 1331. The court of appeals had jurisdiction under 28 U.S.C. § 1291 and 28 U.S.C. § 636(c)(3). The court of appeals entered its judgment on October 29, 2002, and denied petitioners' timely motion for rehearing or rehearing *en banc* on April 12, 2004. On June 29, 2004, Justice Kennedy granted petitioners' application to extend the time to file this petition for a writ of certiorari to August 10, 2004. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

7 U.S.C. § 6c(b):

> No person shall offer to enter into ... any transaction involving any commodity regulated under this chapter which is of the character of, or is commonly known to the trade as, an "option" ... , contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe.

17 C.F.R. § 33.10(a), (c):

> It shall be unlawful for any person directly or indirectly:

(a) To cheat or defraud or attempt to cheat or defraud any other person;

* * *

(c) To deceive or attempt to deceive any other person by any means whatsoever

in or in connection with an offer to enter into, the entry into, the confirmation of the execution of, or the maintenance of, any commodity option transaction.

STATEMENT

Petitioners aired a television commercial and conducted a seminar advertising their commodities brokerage business, believing in good faith that these promotions were truthful and not misleading. The district court, after a trial, rejected the fraud claims brought by the Commodity Futures Trading Commission, concluding that petitioners' speech was not misleading and, even if it was, petitioners were not reckless and did not intend to mislead anybody. In a split decision, the Eleventh Circuit reversed, finding as a matter of law that petitioners' speech was misleading, that they fraudulently omitted to disclose the firm's trading record, and that they possessed scienter because their speech demonstrated an extreme departure from ordinary standards of care.

The Eleventh Circuit's holding on scienter joins the minority side of a circuit split on an issue previously left open by this Court. Its analysis also raises significant issues regarding the legal standard for fraudulent omissions and the deference due the finder of fact in evaluating the impact of speech on an objectively reasonable listener. The Eleventh Circuit's approach is difficult to square with decisions of this Court and with the standards in other areas of law governing misleading speech.

To address these issues and to alleviate the First Amendment concerns raised by the Eleventh Circuit's decision, this Court should grant review.

1. Statutory and Regulatory Framework

Section 4c(b) of the Commodity Exchange Act ("Act"), codified at 7 U.S.C. § 6c(b), authorizes the Commodity Futures Trading Commission ("Commission" or "CFTC") to regulate commodity option contracts. Under this authority, the Commission promulgated Rule 33.10, making it unlawful "[t]o cheat or defraud or attempt to cheat or defraud any other person," or "[t]o deceive or attempt to deceive any other person by any means whatsoever" in connection with any commodity option transaction. 17 C.F.R. § 33.10(a), (c).

The prohibitory language of Rule 33.10 is copied almost verbatim from § 4b of the Act, which makes it unlawful "to cheat or defraud or attempt to cheat or defraud," or "willfully to deceive or attempt to deceive" another person in connection with a commodity futures contract. § 4b(A), (C), codified at 7 U.S.C. § 6b(a)(i), (iii). The Commission interprets both provisions as requiring scienter. *See In re Staryk*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,206, at 45,810, 1997 WL 778236, at *11 (CFTC Dec. 18, 1997).

This Court has stated that "[t]he language of § 4b is similar to that of § 10(b) of the Securities Exchange Act of 1934," and called SEC Rule 10b-5 "analogous" to the Act's anti-fraud provisions. *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353, 389 n.88, 394 (1982). Since *Curran*, "courts faced with interpreting the anti-fraud provisions of the Commodities Exchange Act look to the more developed body of law addressing section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5." *FDIC v. UMIC, Inc.*, 136 F.3d 1375, 1384 n.4 (10th Cir. 1998).

2. The Proceedings to Date

Petitioner Raymond Fitzgerald owned a full-service commodities brokerage firm, petitioner R.J. Fitzgerald & Co. ("the firm"), a moderately successful business with over one thousand accounts. His spouse, petitioner Leiza Fitzgerald, was a licensed broker and part-time employee of the firm.

Although the firm offered advice, customers controlled all their own trading decisions. Pet. App. 45a-48a.

In early 1998, the firm recommended a trading strategy to some of its customers based upon extensive research predicting increased volatility in corn futures prices. It also sought to attract new customers with a television commercial on CNBC that discussed the potential impact of future weather events on grain markets and a seminar at a local library. These promotions yielded little to no business and were discontinued after being used a handful of times. Pet. App. 59a. Ultimately, the heightened market volatility did not yield the higher prices the firm predicted, and customers who adopted the recommended strategy lost substantially all the money that they put into the trade. Pet. App. 64a.

In July 1999, the CFTC's Division of Enforcement filed a complaint in federal district court alleging that petitioners and other employees of the firm engaged in a pattern and practice of fraud in violation of Rule 33.10 and other provisions. The specter of an investigation drove away the firm's customers, and it ceased operation completely by the end of 1999. In early 2001, the case was tried before United States Magistrate Judge Mary S. Scriven pursuant to 28 U.S.C. § 636(c) and Fed. R. Civ. P. 73. The three-week bench trial included testimony by Mr. and Mrs. Fitzgerald, expert witnesses, and a host of the firm's customers and employees.

At the close of the government's evidence, the trial court issued a "directed verdict" for petitioners on several claims. The court deemed "not credible" the expert proffered by the CFTC and found no evidence that petitioners ever made a misleading claim that customers could profit by trading based on seasonal trends in demand. Pet. App. 83a. The court also held that petitioners had no duty to disclose the firm's win/loss record because they made no representations about the success of the firm's clients and because the CFTC did not establish the firm's track record at the relevant point in time. Pet. App. 79a-80a.

After trial, the court entered final judgment for petitioners on the remaining claims, holding that the firm consistently provided all legally required risk disclosures, that none of its advertising or promotions were misleading, and that, in any case, none of the petitioners possessed scienter for fraud. The trial court held that virtually all significant customer and expert testimony offered by the CFTC was not credible, and rejected its assertions of intentional misconduct by petitioners. In contrast, the court found that Mr. and Mrs. Fitzgerald "testified credibly" about their attention to compliance, truthfulness, and full risk disclosure in training, solicitation, and trading. Pet. App. 58a-59a. The court also held that petitioners took reasonable steps to ensure that the firm complied with the law, and that circumstantial evidence further demonstrated an absence of scienter. For example, Mr. Fitzgerald edited the commercial to include additional risk disclosures and to display them more prominently. Pet App. 64a. He submitted both the commercial and the seminar script for review to the legal compliance department of Iowa Grain, the firm's guarantor, and published them only after obtaining approval and incorporating all recommended changes. The court also recognized that petitioners modeled their profit illustrations on publications by industry regulators like the National Futures Association and provided "ample disclosure regarding the high risks involved." Pet. App. 69a.

After petitioners filed a motion for attorney's fees, the CFTC appealed the judgment. The CFTC's briefs were intensely factual, relying heavily on rejected evidence and witness testimony that the trial court rejected as not credible. Nevertheless, two judges of the Eleventh Circuit panel accepted the CFTC's argument that, "regardless of the [district] Court's factual findings based on witness credibility, Defendants committed fraud ... as a matter of law." Pet. App. 6a. Ignoring the testimony and evidence presented at trial, the majority limited its analysis to a *de novo* review of the text of the commercial and the script of the seminar, which it

characterized as "undisputed matters of record." Pet. App. 13a. It held that these promotions were "unbalanced" and misleading as a matter of law based on their "*overall message*," and how that message would be interpreted by an "objectively reasonable" person. Pet App. 13a, 17a. The court also found that petitioners committed fraud as a matter of law by not disclosing that "more than 95% of the firm's clientele lost money," without recognizing or overturning the trial court's finding that the CFTC did not establish any factual basis for the firm's trading record. Pet. App. 19a.

The majority also found scienter for fraud as a matter of law because the text of the commercial and seminar demonstrated that petitioners "deviated in an extreme manner from the standards of ordinary care." Pet. App. 15a, 19a. Its basis for this conclusion was that "this Court and the CFTC have previously condemned" similar promotions. Pet. App. 15a, 19a. The majority did not address the testimonial and circumstantial evidence of subjective good faith or overturn the trial court's findings, but ruled that the promotions themselves were dispositive. Pet. App. 15a-17a, 18a-19a. Accordingly, the court of appeals found petitioners committed fraud in violation of Rule 33.10 and remanded.

Circuit Judge Wilson dissented. After a detailed analysis of petitioners' speech as well as testimonial and circumstantial evidence, he concluded that there were "no misleading or deceptive statements" in the commercial and seminar, and that the promotions at issue "effectively and sufficiently disclose[d] the magnitude of risk involved." Pet. App. 37a, 35a. He noted that the majority failed to identify any source of a "duty ... to disclose [the firm's] prior track record" as required to make such an omission fraudulent. Pet. App. 42a. He also rejected the notion that scienter could be established by mere reference to what he called the majority's "oversimplifications of prior cases." Pet. App. 37a.

After pending for sixteen months, petitioners' timely request for rehearing or rehearing *en banc* was denied.

REASONS FOR GRANTING THE WRIT

Today, in some circuits but not in others, a broker who genuinely believed that his assertions were true and not misleading can be guilty of fraud if a court decides, after the fact, that his speech was misleading. This divergence flows from the question, repeatedly recognized but never addressed by this Court, "whether, in some circumstances, reckless behavior is sufficient for civil liability under" the commodities and securities laws. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94 n.12 (1976). The circuits generally agree that some form of recklessness can satisfy the scienter requirement for commodities or securities fraud. But a split has developed because "the term recklessness is not self-defining." *Farmer v. Brennan*, 511 U.S. 825, 836 (1994). On the one hand, the objective standard "calls a person reckless who acts ... in the face of an unjustifiably high risk of harm that is either known or so obvious that it should be known." *Id.* On the other hand, the subjective standard "permits a finding of recklessness only when a person disregards a risk of harm of which he is aware." *Id.* at 837. The Eleventh Circuit applied an objective test and found petitioners guilty of fraud; but they would have been innocent, based on the trial court's findings, in circuits where a defendant must be "cognitively aware of the danger" in order to possess "the requisite subjective intent." *Saba v. Compagnie Nationale Air France*, 78 F.3d 664, 669 (D.C. Cir. 1996). This case presents an opportunity to resolve this important issue.

This case also raises significant questions regarding the standards for holding speech misleading. Both the Eleventh Circuit's *de novo* assessment of the effect of speech on a reasonable listener and its broad view of when an omission is misleading are difficult to square with decisions of this and other courts. Taken together with its determination of scienter as a matter of law, the Eleventh Circuit's approach to fraud raises serious First Amendment concerns. Accordingly, review by this Court should be granted.

I. THE DECISION BELOW EXACERBATES A CIRCUIT SPLIT AS TO WHETHER OBJECTIVE "RECKLESSNESS" CONSTITUTES SCIENTER FOR COMMODITIES OR SECURITIES FRAUD

Like the parallel fraud provisions of the securities laws, Rule 33.10 and § 4b of the Act require *scienter*, that is, "a mental state embracing intent to deceive, manipulate, or defraud." *Hochfelder*, 425 U.S. at 193-94 n.12 (establishing the scienter requirement for securities fraud); *see also Curran*, 456 U.S. at 389 n.88, 394 (referring to securities and commodities fraud provisions as "analogous"); *Hammond v. Smith Barney, Harris Upham & Co.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep ¶ 24,617, at 36,658-59; 1990 WL 282810, at *5 (CFTC Mar. 1, 1990) (following the federal courts' "symmetrical approach" to scienter requirements for securities and commodities fraud); . *Hochfelder* explained that the language of § 10(b) (making unlawful "any manipulative or deceptive device or contrivance") "clearly connotes intentional misconduct." 425 U.S. at 197, 201. An identical scienter requirement is found in the language of § 4b and Rule 33.10 that makes it unlawful "to cheat or defraud" or "to deceive" any person. *See Staryk*, 1997 WL 778236, at *10 (holding that these words "convey clear connotations of wrongful intent"); *CFTC v. Savage*, 611 F.2d 270, 284 n.14 (9th Cir. 1980) (noting that the Act's language and legislative history emphasize prevention of "fraud and other intentional actions").

Overturning several lower court decisions permitting a finding of securities fraud based on negligence, the Court noted in *Hochfelder*:

> In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.

425 U.S. at 193-94 n.12. The Court has on several subsequent occasions reserved decision on this question.[1]

As elaborated in the following sections, a well recognized split has developed among the circuits as to whether objectively reckless conduct, without more, establishes scienter for commodities or securities fraud.[2] The source of the split is that "the term recklessness is not self-defining." *Farmer*, 511 U.S. at 836. In *Farmer*, the Court addressed a similar split on the question whether the Eighth Amendment requires "a subjective standard of recklessness" for a claim based on prison conditions. *Id.* at 832. An objective approach

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[1] *See Aaron v. SEC*, 446 U.S. 680, 686 n.5 (1980) (reserving the question "whether, under some circumstances, scienter may also include reckless behavior"); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.4, 379 n.5 (1983) (recognizing "the prevailing view" that reckless behavior can satisfy the scienter requirement for securities fraud, and referring to the "analogous" provisions of the commodities laws); *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 508 U.S. 959 (1993) (granting certiorari on whether recklessness constitutes scienter for aiding and abetting securities fraud), 511 U.S. 164, 191 (1994) (deciding the case on other grounds).

[2] Several commentators have recognized the disparate approaches to scienter among the lower courts and the need for resolution by this Court. *See, e.g.*, 2 Thomas Hazen, *The Law of Securities Regulation* § 12.8[3], at 434 (4th ed. 2002) ("Resolution of the availability of a recklessness standard, as well as a more explicit definition, must await Supreme Court determination."); 2 Philip Johnson & Thomas Hazen, *Commodities Regulation* § 5.08[1], at 5-91 (3d ed. 2003) ("[T]he wealth of decisions regarding intent in fraud cases ... offer solace for nearly every possible formulation."); William Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 Hous. L. Rev. 121, 125-26 (1997) (discussing the circuit split on "the issue of recklessness raised in *Hochfelder*," and noting that, in 1995, Congress left "the question of the existence of that basis of liability and its definition back in the hands of the Supreme Court"); Paul Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense*, 11 J. Corp. L. 179, 180 (1986) ("There is little uniformity ... among the circuits or even among different panels of the same circuit, on how proof of recklessness should be used to satisfy scienter.").

"generally calls a person reckless who acts or (if the person has a duty to act) fails to act in the face of an unjustifiably high risk of harm that is either known or so obvious that it should be known." *Id.* at 836. This standard in essence "conclusively presume[s] awareness from a risk's obviousness." *Id.* at 840. The subjective approach, in contrast, "generally permits a finding of recklessness only when a person disregards a risk of harm of which he is aware." *Id.* at 837. Under this standard, an obvious risk may justify an inference of subjective knowledge, "but the inference cannot be conclusive, for we know that people are not always conscious of what reasonable people would be conscious of." *Id.* at 842 (quoting 1 W. LaFave & A. Scott, *Substantive Criminal Law* § 3.7, at 335 (1986)).

Tracking this distinction, the circuit courts have taken two different approaches to scienter for fraud under the commodities and securities laws. In circuits adopting a subjective standard, the relevant question is, what was the defendant's state of mind? Like other circumstantial evidence, objectively reckless behavior may support an inference that the defendant intended to defraud or knew but disregarded the risk that his statements were misleading. In contrast, circuits adopting an objective standard, like the Eleventh Circuit decision below, equate scienter with objectively "reckless" conduct. The relevant question becomes, did defendant depart in an extreme manner from the ordinary standards of care? Once an extreme departure is shown, scienter is conclusively established: good faith is no defense, and further evidence as to the defendant's actual state of mind is irrelevant.

This difference is not merely technical. The objective approach largely collapses scienter into the analysis of whether a defendant made a misrepresentation. Under the subjective approach, the analyses are less intertwined, and what was said may reveal comparatively little about the speaker's state of mind. This difference can significantly affect outcomes, as

it did in the present case. It can also significantly alter the procedural protections available to a fraud defendant. Under an objective test, summary judgment is possible where an extreme departure can be found as a matter of law. But under a subjective test, a genuine dispute as to a defendant's state of mind requires a trial, with the factfinder's determinations entitled to substantial deference under Rule 52 of the Federal Rules of Civil Procedure. *See, e.g., United States v. Yellow Cab Co.*, 338 U.S. 338, 341 (1949) ("Findings as to the design, motive and intent with which men act depend peculiarly upon the credit given to witnesses by those who see and hear them."). Thus, until the split is resolved, whether a defendant is guilty of commodities or securities fraud and the process to which he is entitled may vary significantly based on the circuit in which the case is brought.

A. Several Circuits Apply a Subjective Standard for Scienter Under Which Reckless Conduct Is Merely Evidence of Defendant's State of Mind

In the Ninth Circuit, commodities fraud requires "that [defendant's] acts be done with knowledge of their nature and character." *CFTC v. Savage*, 611 F.2d 270, 283 (9th Cir. 1980) (reversing a judgment finding scienter as a matter of law under § 4b). Recognizing that a defendant's "intent and knowledge are particularly within his personal comprehension," the court held that the defendant's affidavit established a "genuine issue of material fact" as to his subjective mental state. *Id.* at 282-83. Thus, the factfinder's evaluation of a defendant's proffered testimony about his state of mind is *essential*, and unless internally inconsistent, "can virtually never be clear error" subject to reversal on appeal. *Anderson v. City of Bessemer City*, 470 U.S. 564, 575 (1985).[3]

[3] The Ninth Circuit recently reaffirmed this position in a decision that has become the touchstone for the dispute among the circuits over pleading standards under the Private Securities Litigation Reform Act ("PSLRA"), 15 U.S.C. § 78u-4(b)(2) (1997). *In re Silicon Graphics Inc. Sec. Litig.*,

The D.C. Circuit explicitly treats scienter as a subjective inquiry. In *SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1992), the court rejected the SEC's argument – identical to the Eleventh Circuit's holding in the present case – that scienter was established because "it should have been obvious to [defendants] that the advice they received ... was wrong" given their "extensive experience in the securities industry." *Id.* at 642. Instead, the court held that scienter could not be established without evidence of "bad faith." *Id.* Fraud liability could not be imposed absent evidence sufficient to "permit a finding that [defendants] *actually knew* the opinion was wrong or [were] reckless in relying on it." *Id.* (emphasis added). Judge Silberman subsequently explained that, although a defendant's "intent may be inferred from indirect evidence and the reckless nature of his acts," this test cannot be "satisfied by merely showing an extreme departure from standards of ordinary care." *Saba*, 78 F.3d at 668, 669 (discussing *Steadman* and *Farmer*).

The First Circuit applies a similar subjective test. In *Rodriguez v. Montalvo*, 871 F.2d 163 (1st Cir. 1989), then-Judge Breyer affirmed the district court's admission of testimony by a Catholic priest, defendant's "spiritual advisor," because it tended to show an absence of "the 'fraudulent intent' necessary for liability under Rule 10b-5." *Id.* at 165 (citing *SEC v. MacDonald*, 699 F.2d 47, 50-51 (1st Cir. 1983)). *MacDonald* also held that "[d]efendant had a right to testify ...

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183 F.3d 970, 976-77 (9th Cir. 1999); *cf. Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1282-84 (11th Cir. 1999) (discussing the varying standards and explicitly rejecting *Silicon Graphics*). *Silicon Graphics* held that *Hochfelder* compels treating recklessness "as a form of intentional or knowing misconduct." 183 F.3d at 976. Thus, in the Ninth Circuit, a securities fraud plaintiff must "plead, at a minimum, particular facts giving rise to a strong inference of *deliberate or conscious recklessness*." *Id.* at 979 (emphasis added).

for the purpose of establishing his state of mind." 699 F.2d at 50-51. *See also Backman v. Polaroid*, 893 F.2d 1405, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,899, at 94,946 (1st Cir. 1990) (holding that it was reversible error not to instruct the jury on good faith as a defense, because "[i]t is possible for a defendant to be objectively reckless – to disregard a danger that would be obvious to the ordinary person – and still act in subjective good faith"), *withdrawn on reh'g en banc*, 910 F.2d 10 (1st Cir. 1990) (ruling for defendant on other grounds).

The Fifth Circuit, although not as explicitly, adopts a subjective approach. That court recently stated that scienter involves "the state of mind of the individual corporate official" who "knows that the statement is false, or is at least deliberately reckless as to its falsity, at the time he or she makes the statement." *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 366 (5th Cir. 2004) (quoting *In re Apple Computer, Inc. Sec. Litig.*, 243 F. Supp. 2d 1012, 1023 (N.D. Cal. 2002)). The court explained that scienter is "an essentially subjective state of mind" that "*must actually exist* in the individual making ... the misrepresentation." *Id.* (emphasis added). *See also, e.g., Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 962 (5th Cir. 1981) (*en banc*) (recognizing the significance of "testimony ... that the parties thought themselves to be under no legal duty to disclose").[4]

Finally, contrary to the agency's litigating position below, the Commission itself interprets the fraud provisions of the Act and its own Rules to require evidence of subjective culpability. An administrative law judge granted summary

[4] Although the Eighth Circuit standard is unclear, its position seems consistent with a subjective standard. *See, e.g., SEC v. Kluesner*, 834 F.2d 1438, 1440 (8th Cir. 1987) (agreeing that the SEC's case was not "substantially justified" and awarding attorney's fees to a fraud defendant where the SEC did not challenge as clearly erroneous the district court's findings based on trial testimony that the defendant "acted with 'reasonable belief' and did not recklessly or intentionally act to deceive others").

judgment against a broker for violating Rule 33.10 by employing egregious solicitations, such as statements to customers that the risk of loss on commodity options was equivalent to the likelihood that someone would "cancel the Fourth of July" or "cancel Memorial Day." *Staryk*, 1997 WL 778236, at *3. In a unanimous decision, the full Commission reversed on appeal. Despite agreeing that Staryk's representations were undeniably misleading or "blatantly false," *id.* at *4, *8-10, it held that "[w]hile the deceptive nature of Staryk's solicitations was determined according to an objective standard, *his intent in making those representations is a subjective question*," and Staryk would be "prejudiced if his state of mind is determined against him without an opportunity for him to appear in person before a trier of fact." *Id.* at *12 (emphasis added); *see also id.* at *11 (discussing *Savage*, 611 F.2d at 282).[5]

B. Several Circuits Equate Scienter with Objectively Reckless Conduct

Some circuits adopt an approach that treats objective recklessness as a synonym for scienter. This formulation has its roots in an extremely amorphous and confusing Seventh Circuit case, *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033 (7th Cir. 1977), that was decided just after *Hochfelder* and contains language supporting every conceivable formulation for recklessness. *Sundstrand* defined recklessness as "an extreme departure from the standards of ordinary care,

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[5] The SEC has similarly recognized that "[s]ubjective good faith is inconsistent with a finding of knowing or intentional, *including reckless*, conduct" under the fraud provisions of the securities laws. Amendments to Rule 102(e) of the Commission's Rules of Practice, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,052, at 80,849 (Oct. 19, 1998), *discussed in Marrie v. SEC*, __ F.3d __, 2004 WL 1585848, at *6-7 (D.C. Cir. July 16, 2004) (noting that, unlike fraud provisions, SEC Rule 102(e) governing "improper professional conduct" permits liability without scienter by showing an "extreme departure from standards of ordinary care").

and which presents a danger of misleading the buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Id.* (quoting *Franke v. Midwestern Okla. Devel. Auth.*, 428 F. Supp. 719 (W.D. Okla. 1976)). The court described the *Franke* test as having an objective and subjective component, *id.* at 1045 n.19 & n.20, but then equated the second component with a "reasonable man" standard, *id.* at 1045. *Sundstrand* recited the flatly wrong statement that "good faith is not appropriate as a defense to reckless or intentional behavior." *id.* at 1044 n.17 (citing *McLean v. Alexander*, 420 F. Supp. 1057, 1081 (D. Del. 1976)).[6] *Sundstrand* also relied on Oliver Wendell Holmes, who defined recklessness as "a general objective standard" whereby a man making a false statement "is liable, whatever was the state of his mind, and although he individually may have been perfectly free from wickedness in making it." O. Holmes, The Common Law 136 (Dover 1991); *cf. Farmer*, 511 U.S. at 837 (recognizing and implicitly rejecting Holmes's "objective approach to criminal recklessness"). As a result, subsequent courts virtually never reference *Sundstrand*'s subjective gloss, instead holding that recklessness is established if a danger is "obvious" such that a reasonable person in defendant's position must have been aware of it. *See* Milich, 11 J. Corp. L. at 194-95 (explaining that the *Franke* definition "creates an irrebuttable presumption of fraud based on an objective assessment that the defendant behaved recklessly"); Kuehnle, 34 Hous. L. Rev. at 180 (describing the "problematic origin" of this definition in *Franke*'s reliance on a common law definition of recklessness for physical torts, as opposed to fraud).

Taking exactly this approach, the Eleventh Circuit decision below equates scienter with objective recklessness: "For

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[6] Subsequent to *Sundstrand*, the Third Circuit reversed *McLean* on precisely this point, by equating scienter with "bad faith." 599 F.2d 1190, 1198 (3d Cir. 1979).

purposes of fraud or deceit in an enforcement action, scienter is established ... if Defendant's conduct represents an extreme departure from the standards of ordinary care." Pet. App. 12a. Thus, the court of appeals found scienter "as a matter of law" because Mr. Fitzgerald, "as a federally registered professional, knowledgeable in the nuances and complexities of the industry, deviated in an extreme manner from the standards of ordinary care." Pet. App. 15a.[7] It "premised" this conclusion solely "on the fact that this Court and the CFTC have previously condemned attempts to attract customers" with supposedly similar promotions. Pet. App. 15a. The court of appeals rejected the argument that it should defer to the trial court's findings as to the defendants' state of mind. Instead, it accepted the CFTC's position that, "*regardless of the [district] Court's factual findings based on witness credibility*, Defendants committed fraud ... as a matter of law." Pet. App. 6a. (emphasis added).

The Sixth Circuit also defines scienter as "highly unreasonable conduct which is an extreme departure from standards of ordinary care." *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550 (6th Cir. 2001) (*en banc*) (interpreting and applying Rule 10b-5 and the PSLRA). In a 7–6 decision, the majority rejected the position that scienter requires facts sufficient to justify an "inference that management *actually knew* its statements were false or misleading." *Id.* at 572 (Kennedy, J., dissenting) (emphasis added). Similarly, that court previously held that scienter was established where certain errors were "'so obvious that *any reasonable man would have known of them.*'" *In re Comshare Inc. Sec. Litig.*, 183 F.3d 542, 553 (6th Cir. 1999) (emphasis added) (quoting *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979)). In the Sixth Circuit, *Hochfelder* is limited to "its

[7] Notably, the court of appeals reversed the trial court's judgment in favor of Mrs. Fitzgerald but offered no basis for its necessarily implicit conclusion that Mrs. Fitzgerald also possessed scienter for fraud.

specific holding that mere negligence is not enough for liability," and "the danger" that statements are misleading "need not be known" to the defendant. 598 F.2d at 1025.

The Second Circuit also articulates what amounts to an objective test for recklessness, echoing the *Sundstrand* error by holding that "good faith does not constitute a defense to reckless or intentional conduct." *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46 n.15 (2d Cir. 1978) (citing the later-reversed district court decision in *McLean*). Similarly, the Second Circuit has held that scienter can be established by showing that defendants had "access to information contradicting their public statements," because "[u]nder such circumstances, defendants knew *or, more importantly, should have known* that they were misrepresenting material facts related to the corporation." *Kalnit v. Eichler*, 264 F.3d 131, 142 (2d Cir. 2001) (quoting *Novak v. Kasaks*, 216 F.3d 300, 308 (2d Cir. 2000)) (emphasis added). Applying these pleading decisions to proof issues, district courts within the Second Circuit have rejected the need to inquire whether a defendant subjectively appreciated the risk that his statements were false or misleading. For example, in *SEC v. Credit Bancorp, Ltd.*, 195 F. Supp. 2d 475 (S.D.N.Y. 2002), the court granted summary judgment on fraud claims against a defendant who asserted that he was misled by another party and was therefore subjectively unaware that his own statements were false. "The question is not whether he was 'duped' into believing ... misrepresentations, but whether ... he *should have reasonably known otherwise*." *Id.* at 495 (emphasis added). *See also, e.g., In re Mercator Software, Inc. Sec. Litig.*, 161 F. Supp. 2d 143, 149 (D. Conn. 2001) (citing *Novak* to find adequate a pleading that defendants "should have known" that certain statements were false).[8]

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[8] Other courts have not clearly articulated a position, but appear to favor an objective approach. Despite its previous decision equating scienter with "bad faith," *see McLean*, *supra* n.6, the Third Circuit more recently

C. The Objective Approach to Scienter Adopted by the Decision Below Is Wrong

The language of Rule 33.10 and the Court's decision in *Hochfelder* make clear that, to satisfy the scienter requirement for commodities fraud, recklessness must constitute the equivalent of intentional conduct. The operative provisions of Rule 33.10, making it unlawful "to cheat or defraud" or "to deceive" any person, "convey clear connotations of wrongful intent." *Staryk*, 1997 WL 778236, at *10; *see also Savage*, 611 F.2d at 284 n.14 (explaining that the Act's legislative history emphasizes prevention of "fraud and other intentional actions"). And while *Hochfelder* left open the possibility that recklessness could, in some circumstances, satisfy the scienter requirement, the Court expressly referred to "certain areas of the law" in which "recklessness is considered to be *a form of intentional conduct*." 425 U.S. at 194, n.12 (emphasis added). The D.C. Circuit has explained that only a subjective formulation of recklessness "is a legitimate substitution for intent to do the proscribed act because, if shown, it is a proxy for that forbidden intent." *Saba*, 78 F.3d

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stated that "a subjective belief that demonstrates good faith" is not inconsistent with finding of recklessness and, therefore, scienter. *SEC v. Infinity Group Co.*, 212 F.3d 180, 193 & n.16 (3d Cir. 2000). The Tenth Circuit suggests that scienter can be based on objective recklessness less than that required to infer actual knowledge, *see, e.g., Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1232 (10th Cir. 1996); *see also, e.g., SEC v. Autocorp Equities, Inc.*, 292 F. Supp. 2d 1310, 1322 (D. Utah 2003) (finding fraud as a matter of law based on objective recklessness). However, an unpublished Tenth Circuit decision (cited by the CFTC in *Staryk*, 1997 WL 778236, at *11) clearly applied a subjective test in reversing summary judgment against a defendant who proffered testimony that he did not know of the alleged conduct. *SEC v. Johnston*, 972 F.2d 357, 1992 WL 180130, at *2 & n.5 (10th Cir. 1992) (stating that scienter can be found as a matter of law only if defendant's testimony "were *impossible* to believe") (emphasis in original).

at 668 (citing *Hochfelder*, 425 U.S. at 193 & n.12). Discussing *Farmer*, *Saba* explained that the "Supreme Court's reasoning makes quite clear that the key divide is not between nominally 'civil' and 'criminal' recklessness, but between a means of imposing liability that requires a showing of intent and one that does not." *Id.* at 669 (footnote omitted). Thus, because the securities laws require an equivalent of intent, scienter requires a subjective inquiry, and cannot be "satisfied by merely showing an extreme departure from standards of ordinary care." *Id.*

Hochfelder also equated scienter with a finding that a person "acted other than in good faith." 425 U.S. at 206. The English securities fraud case of *Derry v. Peek*, 14 App. Cas. 337, 5 T.L.R. 625 (H.L. 1889), established the rule that good faith is an absolute defense to fraud, such that fraud liability cannot be imposed on defendants who "honestly believe[d] the truth of the[ir] representation." *Id.* at 345. Addressing the "confusion between that which is evidence of fraud and that which constitutes it," *id.* at 369, Lord Herschell explained that objectively reckless conduct should not be equated with fraud, even though it may be used "to assert circumstantially that the defendant lacked an honest belief in the truth of his statement," Milich, 11 J. Corp. L. at 189.

The Eleventh Circuit's decision used objective conduct not as evidence of petitioners' state of mind, but as a *substitute* for such evidence. Its holding that "scienter is established ... if Defendant's conduct represents an extreme departure from the standards of ordinary care," Pet. App. 12a, cannot be reconciled with the decisions of this Court, Rule 33.10, or the common law roots of the fraud statutes.

II. THE COURT OF APPEALS' RULING THAT THE CHALLENGED PROMOTIONS WERE MISLEADING AS A MATTER OF LAW IS INCONSISTENT WITH THE DECISIONS OF THIS AND OTHER COURTS

The decision below goes beyond punishing petitioners for truthful speech uttered in good faith by punishing them for *failing* to make statements that they had no duty to make. Compounding its improper analysis of scienter, the majority held that petitioners committed fraud as a matter of law by failing to disclose the firm's trading record, but identified no basis for finding that petitioners had any duty to make such disclosures. Eliminating any remaining procedural safeguards, the majority also refused to defer to the trial court's findings as to what a reasonable listener would have inferred from petitioners' advertisements, instead undertaking its own independent analysis and concluding that the promotions were "on balance" misleading as a matter of law. In both respects, the decision below is difficult to square with the decisions of this and other courts, highlighting an issue that merits this Court's clarification.

A. The Eleventh Circuit Applied an Incorrect Legal Standard by Imposing Fraud Liability for Failure To Disclose Information That Petitioners Had No Duty To Disclose

The Eleventh Circuit held that petitioners committed fraud by not disclosing the "fact" that "more than 95% of Defendants' customers lost money" because that was information that "a reasonable investor *surely* would want to know." Pet. App. 19a & n.9. Setting aside that this "fact" was directly contradicted by the trial court's findings, the decision below conflicts with established law by failing to identify any statute, regulation, or affirmative statement by petitioners that gave rise to a duty to disclose the firm's trading record. *See* Pet. App. 19a (listing statements about potential magnitudes of profits and losses but no representations about their likeli-

hood or the successes of past customers).

It is plain that failure to disclose even material information is not fraudulent absent a duty to disclose. *See, e.g., Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988) ("Silence, absent a duty to disclose, is not misleading."); *Chiarella v. United States*, 445 U.S. 222, 235 (1980) (A duty to speak "does not arise from the mere possession of nonpublic market information."). As the CFTC conceded, petitioners had no statutory or regulatory duty to disclose the firm's trading record. Accordingly, petitioners would have a duty to disclose the firm's customers' trading record only if they made statements that would be misleading unless qualified by such a disclosure, *e.g.*, asserting that they have a "special ability to achieve profits for customers." *Lehoczky v. Gerald, Inc.*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,441, at 42924-25, 1995 WL 355284, at *9 (CFTC June 12, 1995), *aff'd sub nom Lehoczky v. CFTC*, 125 F.3d 844 (2d Cir. 1997). *See also Modlin v. Cane*, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,059, at 49,549-50 (CFTC Mar. 15, 2000) (disclosure required to cure representations that defendant "would jump into the East River" if he was unable to generate a profit).

There are strong constitutional reasons for insisting on such a connection between a person's speech and any mandatory disclosures. "[U]njustified or unduly burdensome disclosure requirements might offend the First Amendment by chilling protected commercial speech." *Zauderer v. Office of Disciplinary Counsel of the Supreme Court of Ohio*, 471 U.S. 626, 651 (1985). Accordingly, although "[t]he government can impose affirmative disclosures in commercial advertising," such disclosures must be "reasonably related to preventing the public from being deceived or misled." *Commodity Trend Serv., Inc. v. CFTC*, 233 F.3d 981, 994 (7th Cir. 2000). And, such a disclosure requirement "must be no broader than necessary to prevent the deceptive or misleading advertising engaged in by the party." *Id.*

The Eleventh Circuit contravened established law and offended these constitutional principles by rejecting the need to link the disclosures it mandated with petitioners' affirmative representations. Instead, the majority opinion equated materiality with a duty to disclose, by ruling that:

> The focus of the inquiry is not on how well or how poorly others firms have done or even, in some circumstances, whether a firm has affirmatively boasted about a particular win-loss record. Rather, the judicial cross hairs in this case fall squarely on what the investor would reasonably want to know before deciding to commit money to a broker.

Pet. App. 20a; *cf.* Pet. App. 79a (finding no evidence that petitioners "made any affirmative representation about the success of their customers, specifically or generally"). This violates the principle that "[m]ateriality alone is not sufficient to place a company under a duty of disclosure." *In re Sofamor Danek Group, Inc.*, 123 F.3d 394, 400 (6th Cir. 1997). By abandoning the requirement of a nexus between petitioners' speech and the disclosure duty it imposed, the decision below establishes a vague and burdensome rule that conflates a duty to disclose information with the materiality of that information and thereby threatens to chill legitimate commercial speech protected by the First Amendment.

B. The Eleventh Circuit Improperly Substituted Its Own Views for the Trial Court's Judgment That the Promotions Were Not Misleading

The Eleventh Circuit rejected any need to defer to the trial court's determinations under Rule 52 of the Federal Rules of Civil Procedure. It justified its rejection of Rule 52 by asserting that it could read the petitioners' promotions as well as the district court. But whether speech is misleading turns on context, and the Eleventh Circuit paid context no heed.

The majority admittedly evaluated petitioners' speech by conducting an independent review of its text in isolation

from all other testimony and evidence:

> The parties obviously do not contest the textual content of the Commercial. The actual words of the Commercial and how the Commercial physically appeared on television are undisputed matters of record and do not require us to second guess what the District Court concluded with regard to witness demeanor and credibility at the bench trial. That being said, we are persuaded that these undisputed facts demonstrate fraud and deception as a matter of law.

Pet. App. 13a; *see also* Pet. App. 17a-18a (applying similar treatment to the seminar).

The court of appeals ignored substantial contextual evidence supporting the trial court's conclusion that petitioners' speech was not misleading. For example, documents showed that the profit illustrations in the commercial and seminar were substantially similar to those found in investor education publications by the Chicago Board of Trade and the National Futures Association, and petitioners testified that they "plagiarized" those materials, believing in their legitimacy. Pet. App. 9a n.4, 31a, 69a. Similarly, the majority ignored evidence putting the seminar into context, including the documents that were handed out to seminar attendees and the testimony of the one CFTC trial witness who attended the seminar and admitted "that risk of loss was described to her." Pet. App. 69a. At the same time, the majority selectively extracted testimony from the record to support its reasoning, even where the evidence was rejected by the trial court.[9]

[9] For example, the majority held that the firm fraudulently failed to disclose its trading record because "RJFCO's principal, Raymond Fitzgerald, testified that more than 95% of Defendants' customers lost money." Pet. App. 19a n.9. That supposed "fact" was taken out of context from a deposition, and had been expressly rejected by the trial court because it was contradicted by other record evidence and because it did not relate to the time period when petitioners supposedly had a duty to make such a disclosure. Further illustrating the majority's loose approach

The Eleventh Circuit's non-deferential approach contravenes the standards for appellate review established by this Court. When determining mixed questions of law and fact under the securities and commodities laws – such as whether speech is misleading – "the underlying objective facts, which will often be free from dispute, are *merely the starting point* for the ultimate determination of ... the inferences a 'reasonable [person]' would draw from a given set of facts." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976) (emphasis added) (reversing a court of appeals for determining materiality "as a matter of law"); *see also, e.g., Isquith v. Middle South Utils., Inc.*, 847 F.2d 186, 210-11 (5th Cir. 1988) (holding that "whether information has been adequately disclosed is a mixed question of fact and law and, therefore, is a question for a jury"). Thus, the trial court's judgment should have been affirmed unless "reasonable minds could not differ" in concluding that the statements "taken together and in context, were misleading." *Silver v. H&R Block, Inc.*, 105 F.3d 394, 396 (8th Cir. 1997). But as made clear by the opinion of the trial court and Judge Wilson's dissent, that standard was not met here.

The approach adopted below is also inconsistent with the law applicable to misleading speech under the Lanham Act. "Unlike the requirements of a claim of literal falsity, the plaintiff alleging a misleading advertisement has the burden of proving that a substantial portion of the audience for that advertisement was actually misled." *Clorox Co. Puerto Rico v. Proctor & Gamble Commercial Co.*, 228 F.3d 24, 36 (1st Cir. 2000). In such cases, literally true statements can virtu-

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to the record, Judge Tjoflat's concurring opinion explains that the statement "only investment capital should be used" does not sufficiently disclose risk. Pet. App. 24a. The commercial actually said "only *risk* capital should be used," meaning money that the trader could afford to lose. Pet. App. 35a (Wilson, J., dissenting).

ally never be deemed misleading "as a matter of law"; rather, a plaintiff must present extrinsic evidence, such as a consumer survey or substantial witness testimony, establishing an actual tendency to deceive. *Pizza Hut, Inc. v. Papa John's Int'l*, 227 F.3d 489, 497 (5th Cir. 2000); *American Council of Certified Podiatric Physicians & Surgeons v. American Bd. of Podiatric Surgery, Inc.*, 185 F.3d 606, 616 (6th Cir. 1999). By permitting a court to find a television commercial misleading as a matter of law based solely on its text, the decision below threatens to unravel the settled body of law applicable to literally true advertising.

III. THE DECISION BELOW INVOLVES IMPORTANT AND RECURRING QUESTIONS OF FEDERAL LAW THAT MERIT THIS COURT'S IMMEDIATE REVIEW

A. The Questions Raised Are Critical to a Host of Commodities and Securities Actions

The issues presented by this case are plainly of recurring importance. Both scienter and misrepresentation are essential elements of fraud claims under the securities and commodities laws. As such, the proper treatment of these issues is critical in cases brought by the enforcement agencies in federal district courts and in administrative proceedings, *see, e.g., Staryk*, 1997 WL 778236,[10] as well as in private lawsuits, including "the large number of securities-fraud class actions that are filed in federal court." *See* Brief for the United States as Amicus Curiae, On Petition for a Writ of Certiorari to the U.S. Court of Appeals for the Ninth Circuit,

[10] Indeed, the application of these standards to enforcement actions both in district court and in administrative proceedings highlights the need for review. In light of the subjective approach to scienter adopted by the Commission in *Staryk*, the CFTC's Division of Enforcement may be inclined to shunt cases lacking subjective evidence of intent into the district courts, thus compounding the extent to which the forum determines the outcome.

Dura Pharms. v. Broudo, No. 03-932, at 13-14 (filed May 28, 2004), *cert. granted*, __ U.S. __ (June 28, 2004) (explaining important and recurring nature of questions involving standards for securities fraud).

Under the Eleventh Circuit's standard, fraud liability can be imposed without regard to whether a defendant understood that his speech was misleading or whether there was any evidence that any listener actually was misled. Absent resolution by this Court, defendants in some circuits can essentially be found guilty of *inadvertently* committing fraud, while defendants in other circuits must be found to have had subjective culpability. Moreover, under the Eleventh Circuit's duty-to-disclose analysis, potential defendants must not only avoid unwittingly saying something that might later be deemed misleading, but also attempt to guess, and make sure they *do* say, anything a district court or appellate court might later conclude that listeners would want to know.

The Eleventh Circuit's determination of scienter and misrepresentations as a matter of law based solely on the language of petitioners' promotions also undermines substantial procedural protections by rendering irrelevant the entire course of a three-week bench trial. In the wake of the decision, a district court encountering an allegation that a particular advertisement or promotion is misleading will be faced with an intractable choice. On the one hand, the decision below suggests that the court can simply review the advertisement itself and determine whether, based on its own understanding of precedent, the advertisement is misleading. On the other hand, this Court's decision in *TSC Industries* indicates that the advertisement itself is "merely the starting point," and that the court should admit and weigh a variety of other evidence. District courts should not be put to this choice of prematurely granting summary judgment versus holding a lengthy trial only to have it later deemed unnecessary. Accordingly, this Court's guidance is necessary.

B. This Case Presents an Appropriate Vehicle To Resolve These Important Questions of Law

This case presents an excellent vehicle for addressing the issues raised. Unlike many other cases arising in this area, here there are no disputed questions of fact. At oral argument before the Eleventh Circuit, the CFTC expressly waived any claim that the trial court's findings were clearly erroneous, and the majority opinion makes clear that it reached its conclusions notwithstanding the trial court's unchallenged findings of fact.

Because the trial court's findings regarding petitioners' subjective state of mind are intact and uncontroverted, this case squarely presents the legal issues in a context that permits this Court to establish the appropriate standard for scienter. The only way the court of appeals' decision can stand is if it is no defense to commodities fraud, as a matter of law, that petitioners acted in good faith and honestly believed that their promotions were not misleading but lawful.

The same is true regarding the standards for assessing whether speech is misleading. Because what is at issue is the court of appeals' determination that the promotions were misleading as a matter of law, without even considering the uncontroverted evidence presented at trial to the contrary, it is not necessary for this Court to embroil itself in factual matters in order to resolve the proper mode of analysis. Similarly, the Court need only address the legal question whether a broker has a duty to disclose all information, not otherwise required by statute or rule, that "a reasonable investor *surely* would want to know," or if that duty arises only when the information is linked to a specific contrary representation. This case thus presents an excellent opportunity for the Court to address both the deference due a trial court's factual findings as to whether speech is misleading and the standards determining what information must be disclosed.

C. To Avoid Chilling Commercial Speech, the Court Should Resolve These Issues Now

Vague standards for fraud liability create the risk of punishing well-intentioned speech that is only later determined to be misleading, and of chilling speech that is, in fact, not misleading. The decision below contributes to the vagueness of the already "arbitrary and conflicting" body of law on commodities fraud, and "fails to offer any useful guidance to actors in this area." Pet. App. 43a. Thus, as the dissent warned, "[c]ommodities brokerage firms should be on the alert – this decision may make it difficult to advertise and solicit business in the future." Pet. App. 44a.

The approach adopted by the Eleventh Circuit threatens to retroactively punish legitimate commercial speech, undertaken in good faith but later deemed misleading. By taking the question of whether speech is misleading out of the hands of the factfinder and resolving the issue as a matter of law, the Eleventh Circuit removed an important protection available to brokers engaged in commercial speech. Rather than being able to present testimonial and documentary evidence demonstrating how their speech would be understood by the relevant audience, brokers will face a federal judge simply reviewing the bare text of a challenged advertisement or promotion and deeming it misleading or not as he or she sees fit. Given the potentially serious consequences of such a determination – including substantial fines and a permanent ban from engaging in the commodities or securities business – brokers will be encouraged to steer clear of legitimate advertising. This runs contrary to the intent of Congress; as the Court has recognized, "speculators" or "investors" are key to the existence of sustainable commodities markets, because such speculators "broaden a market" to make possible the execution of larger orders by commercial hedgers with minimum price disturbance. *Curran*, 456 U.S. at 359, 360 n.11 (citing H.R. Rep. No. 93-975, at 138 (1974)).

The Eleventh Circuit's treatment of scienter exacerbates

the potential chilling effect of its decision by imposing liability even on those who attempt in good faith to comply with the law. Indeed, a scienter requirement often "may mitigate a law's vagueness." *Village of Hoffman Estates v. Flipside, Hoffman Estates, Inc.*, 455 U.S. 489, 499 (1982). However, the fact that petitioners were held liable for fraud "after studying [the law] and making a conscious effort at compliance" demonstrates that the approach adopted by the Eleventh Circuit creates "a trap for the wary as well as the unwary." *Gentile v. State Bar of Nevada*, 501 U.S. 1030, 1051 (1991). Accordingly, the Eleventh Circuit's approach to the relevant statutes creates inappropriate risks of arbitrary or selective enforcement. *Id.*

Under the Eleventh Circuit's decision, careful and well-intentioned commodities brokers who seek only to comply with the law will be unable to do so with any certainty. They may be chilled from advertising altogether for fear that, like petitioners, they too may have their lives ruined by being charged with, and found guilty of, *inadvertently* committing fraud. By reaching out to reverse the judgment of the trial court, the Eleventh Circuit unnecessarily propelled the law into an area of constitutional peril. Given the potential of the Eleventh Circuit's approach to chill legitimate commercial speech, the Court should not delay in resolving these issues.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

August 10, 2004

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[FILED April 12, 2004]

IN THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 01-14780-JJ

COMMODITY FUTURES TRADING COMMISSION,

Plaintiff-Appellant,

versus

R.J. FITZGERALD & CO., INC.,
RAYMOND FITZGERALD, ET AL.,

Defendants-Cross-
Claimants-Third-Party-
Plaintiffs-Appellees.

On Appeal from the United States District Court
for the Middle District of Florida

ON PETITION(S) FOR REHEARING AND
PETITION(S) FOR REHEARING EN BANC

(Opinion _____, 11th Cir., 19___, _____F.2d _____).

Before: TJOFLAT, WILSON and COWEN*, Circuit Judges.

PER CURIAM:

The Petition(s) for Rehearing are DENIED and no Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules

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* Honorable Robert E. Cowen, United States Circuit Judge for the Third Circuit, sitting by designation.

of Appellate Procedure), the Petition(s) for Rehearing En Banc are DENIED.

ENTERED FOR THE COURT:

s/ Gerald Bard Tjoflat

UNITED STATES CIRCUIT JUDGE

UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

COMMODITY FUTURES TRADING COMMISSION,
Plaintiff-Appellant,

v.

R.J. FITZGERALD & CO., INC., RAYMOND FITZGERALD, LEIZA FITZGERALD, GREG BURNETT, CHUCK KOWALSKI,

Defendants-Cross-Claimants-Third-Party-Plaintiffs-Appellees,

and

AL CORINGRATO,

Defendant-Cross-Defendant,

SCOTT EUBANKS, JOHN RODGERS, et al.,
Third-Party-Defendants.

No. 01-14780

Decided October 29, 2002

Before TJOFLAT, WILSON and COWEN* Circuit Judges. TJOFLAT, Circuit Judge, concurring. WILSON, Circuit Judge, dissenting.

COWEN, Circuit Judge:

Presented in this appeal is the question of liability for fraud and related allegations under the Commodities Exchange Act, 7 U.S.C. §§ 1 *et seq.*, (the "CEA" or "Act") and accompanying regulations. Plaintiff/Appellant Commodities Futures Trading Commission ("CFTC") appeals from a judgment finding all Defendants not liable under the

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* Honorable Robert E. Cowen , U.S. Circuit Judge for the Third Circuit, sitting by designation.

Act for various solicitation and trading activities carried out at R.J. Fitzgerald & Company, Inc. ("RJFCO"). After reviewing the record in this matter, considering the submissions of the parties, and having benefitted from oral argument, we conclude that the District Court erred in not finding liability under the Act as a matter of law for two specific solicitation devices utilized by RJFCO: (1) a television commercial that aired on the "CNBC" cable network in March 1998 (The "Commercial") and (2) a promotional seminar for potential RJFCO customers that also took place in 1998 (the "Seminar"). For the reasons expressed below, we will reverse as to Raymond Fitzgerald, Leiza Fitzgerald and RJFCO, and remand only for enforcement proceedings against those two individuals and the firm.

I. PROCEDURAL BACKGROUND

In 1999, CFTC commenced this CEA enforcement case by filing a Complaint against Defendants/Appellees RJFCO, Raymond Fitzgerald, Leiza Fitzgerald, Chuck Kowlaski, and Greg Burnett, alleging that they were involved in fraudulent solicitations to attract potential customers throughout the United States to invest in commodity options, in violation of the Act and related federal regulations.[1] This Complaint was dismissed essentially for failure to plead fraud with particularity.

The District Court then required CFTC to file an Amended Complaint detailing every fact it intended to prove in establishing liability under the Act. CFTC complied with that request, filing an extensive 138 page, 15 count Complaint which sets the framework for the instant case. The Amended Complaint alleged that Defendants, or some individual Defendants, violated the Act by: (1) committing fraud by misrepresentation or omission of material facts in

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[1] The Complaint also named as a Defendant RJFCO employee Al Coringrato who settled the claim before trial.

connection with the solicitation, maintenance, or execution of commodity futures transactions; (2) operating an introducing brokerage firm to cheat, defraud, deceive, or attempt to cheat, defraud or deceive clients; (3) trading client accounts excessively in order to generate commissions without regard to customer interests ("churning"); (4) failing to provide risk disclosure statements prior to the opening of RJFCO customer accounts; and (5) failing to supervise firm personnel diligently. Defendant Raymond Fitzgerald was charged with "controlling person" liability under the Act. The various allegations in the Amended Complaint encompass claims grounded in 7 U.S.C. § 6c(b), 17 C.F.R. § 33.10(a) and (c), 17 C.F.R. § 166.3, and 7 U.S.C. § 13c(b).

Counts one, two, seven and nine alleged that Raymond Fitzgerald, as principal of RJFCO, RJFCO, Leiza Fitzgerald and Greg Burnett committed fraud by misrepresentation or omission of material facts in connection with the solicitation of commodity futures transactions. Counts three, ten and fifteen charged Raymond Fitzgerald, as principal of RJFCO, RJFCO, Greg Burnett and Chuck Kowalski with operating an introducing brokerage to cheat, defraud, deceive, or attempt to cheat, defraud or deceive clients. Counts four and eleven charged Raymond Fitzgerald, RJFCO, and Greg Burnett with committing fraud by trading client accounts excessively to generate commissions without regard to client interests. Count five charged Raymond Fitzgerald and RJFCO with failing to provide adequate risk disclosure statements prior to opening customer accounts. Counts six, eight, and twelve charged Raymond Fitzgerald, Leiza Fitzgerald and Greg Burnett with failing to supervise diligently the sales practices and solicitations of RJFCO brokers.

After some of the claims in the Amended Complaint were dismissed on summary judgment, the parties agreed, pursuant to 28 U.S.C. § 636(c) and Fed. R. Civ. P. 73, to

conduct a bench trial before a Magistrate Judge[2]. That trial commenced on February 26, 2001. On March 8, 2001, the Court heard oral argument and granted what it labeled a "directed verdict" against a significant part of the CFTC's case. Germane to this appeal, and as will be explained further below, the District Court granted relief to Defendants on that part of the CFTC's claim that the Commercial violated the Act as well as on the claim that Defendants had a duty to disclose their specific trading record (i.e., their success rate) to potential customers.

The trial pressed forward to completion on the remaining claims in the Amended Complaint and concluded on March 19, 2001. Thereafter, the District Court entered extensive findings of fact and conclusions of law, ruling in favor of all Defendants on all counts in the Amended Complaint. *See CFTC v. R.J. Fitzgerald & Co., Inc.*, 173 F. Supp. 2d 1295 (M.D. Fla. 2001). CFTC appeals, essentially arguing that regardless of the Court's factual findings based on witness credibility, Defendants committed fraud and other CEA violations as a matter of law.

II. BACKGROUND FACTS

A. The Defendants

RJFCO was a full service "introducing broker" at all times relevant to this appeal. *See* 7 U.S.C. § 1a. RJFCO's obligations to those with whom it dealt were guaranteed by Iowa Grain Company ("Iowa Grain"), a registered futures commission merchant. RJFCO opened for business in 1992. It operated as a firm designed to service small customer accounts, where the customer base had little experience in commodities markets. RJFCO operated in a perhaps unique manner in the commodities industry in that it used one team of sales brokers for generating customers via telephone calls and a separate team of brokers and traders to do the actual

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[2] Trial before the Magistrate Judge will hereafter be referred to as the "District Court" or the "Court."

trades and monitor accounts. Defendant Raymond Fitzgerald was the principal of RJFCO and was responsible for all decisions, actions, and trading recommendations made or entered into by the firm. Defendant Leiza Fitzgerald's responsibilities at RJFCO involved developing training materials and training sales brokers. Greg Burnett was an associated person at RJFCO and was responsible for supervising traders and brokers. Chuck Kowalski was RJFCO's chief financial analyst, responsible for studying the commodities markets and developing trades and trade strategies.

B. Customer Solicitation Devices

At the heart of this appeal are two solicitation devices used by RJFCO to attract customers to invest in options on futures contracts: the Commercial and the Seminar.

1. The Commercial

The Commercial stated that "the El Nino [weather phenomenon] has struck where expected, and if patterns continue, the effects could be devastating. Droughts, floods, and other adverse conditions could drastically alter the supply and demand dynamics of the corn market . . . ." The Commercial also declared that "with the giant developing nations, such as China and Russia badly in need of grains and world grain supplies put to the test, conditions may exist for profits as high as 200 to 300 percent." This was accompanied by a graphic statement on the television screen that the percentages were a mathematical example of leverage. The Commercial further asserted that "the potential of the corn market may never be greater. Tight U.S. reserves coupled with domestic and worldwide demands could be the formula for a trade you won't want to miss. Find out how as little as $5,000 could translate into profits as high as 200 to 300 percent. Call R.J. Fitzgerald today . . . ."

The Commercial was initially drafted by an advertising agency. When Raymond Fitzgerald first received the script,

he edited it to add additional risk disclosures that would appear just above the firm's phone number, so that anyone watching the Commercial would see the risk disclosure. He further insisted that this disclosure appear more than half the time the Commercial was running. After his edits were done, he sent the script to Iowa Grain's chief compliance officer, Anne Farris. Iowa Grain approved the script on February 18, 1998.

The Commercial actually ran on CNBC for the first half of March, 1998, but did not generate much business. In total, it appeared about eight or nine times and was then discontinued. At some point after its discontinuation, Raymond Fitzgerald was contacted by a National Futures Association ("NFA")[3] compliance officer, who expressed concern over the Commercial's content. More specifically, the NFA officer, David Croom, informed Raymond Fitzgerald that the Commercial was in apparent violation of NFA rules because: (1) it was misleading in that it failed to tell potential customers that the options spoken of were "out-of-the money options" that would require a dramatic move in the options premium value in order for the customer to see gains equal to that claimed in the Commercial; (2) misleadingly gave the impression that weather events were inevitable; (3) did not display the risk of loss statement prominently enough on the screen; and (4) downplayed the risk of loss. In response to this concern, Raymond Fitzgerald informed Croom that the Commercial had already been discontinued and would not be aired again.

At the close of CFTC's case, and before the defense was presented, the District Court entered a directed verdict in favor of Defendants on the part of the claim that the Commercial was fraudulent and violated the CEA. The

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[3] The National Futures Association ("NFA") is a congressionally authorized futures industry self-regulatory organization. The purpose of the NFA is to assure high standards of business conduct by its Members and to protect the public interest.

District Court addressed the Commercial again in its opinion issued after the bench trial, stating that the Commercial was not "misleading or deceptive" and that there was no "intent to defraud." 173 F. Supp. 2d at 1310.

2. RJFCO's 1998 Promotional Seminar

In addition to the Commercial, CFTC alleged CEA violations occurred in a promotional seminar used by RJFCO to attract customers. The Seminar was developed by Leiza Fitzgerald and RJFCO brokers Scott Campbell and Tom West after they attended a training session on the topic conducted by the National Introducing Brokers Association.[4]

The Seminar informed customers that weather patterns, political events, and historical trends can affect the prices of certain commodities. The Seminar also told customers that technical analysis could assist them in the commodity options market, since "history often repeats itself" and "past price action can provide you with clues to future action." Customers were told they could "take advantage" of "fundamental" market moves such as weather events and political events and "technical theory" such as past market movements through either futures or options investing. The Seminar also drew a distinction between investment instruments based on the quantum of risk involved:

> Which one you choose depends on how aggressive or what degree of risk you wish to take on.
>
> If you are highly aggressive and looking for unlimited profit potential as well as unlimited risk than [sic] it would

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[4] Leiza Fitzgerald developed the script of this Seminar based in part on materials from an NFA workbook and manuals from the Chicago Board of Trade. Testimony adduced at the bench trial revealed that RJFCO employees would read the promotional scripts given to them by Leiza Fitzgerald verbatim. The Seminar provided general background on the firm and how the commodities market operates. At the beginning of the Seminar, participants received written risk disclosure material. As with the Commercial, the content of the Seminar was approved by Iowa Grain before it went into action.

> be the futures. But most would like something less aggressive, something offering unlimited profit potential but limited risk—option trade [sic].

On the topic of risk, the Seminar additionally told potential customers: "options on futures allow investors and risk mangers to define risk and limit it to the loss of a premium paid for the right to buy or sell a futures contract while still providing . . . unlimited profit potential."

The RJFCO employees who conducted the Seminar offered what the Seminar script deemed a "very exciting" illustration of how profits could be made on options. Specifically, the Seminar focused on the commodity heating oil, explaining that for the last eighteen years, there was an average increase in that commodity "of 22 cents from the low to the high in the price range" and that a $5,000 investment on a heating oil futures contract would result in $46,200 if there was a 22 cent move in the price. Customers were told that if they wanted "limited risk," they could invest in an option contract, where they would receive "approximately 50% of that profit—46,200 divided by 2 equals $23,100."[5]

In its opinion following the bench trial, the District Court concluded that the Seminar did not violate the CEA. The District Court explained that there was nothing "patently or latently misleading or deceitful" about the profit illustrations used in the seminar. 173 F. Supp. 2d at 1311.

III. DISCUSSION

The District Court had jurisdiction over this case under 7 U.S.C. § 13a-1 and 28 U.S.C. § 1331. We have jurisdiction pursuant to 28 U.S.C. § 636(c)(3) and 28 U.S.C. § 1291.

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[5] Finally, the Seminar had more general advice for potential RJFCO customers: a "big reason" people lose money is "greed" and that "you will never go broke taking a profit, just take it one piece at a time."

It is somewhat unclear from the briefing what specific parts of the judgment below are being challenged by CFTC, especially given the large number of allegations in the extremely lengthy Amended Complaint. CFTC's initial brief requests that this Court "reverse the district court's judgment and remand with instructions to enter judgment in favor of appellant CFTC *on the Amended Complaint*." Appellant's Brief at 57. However, we can construe the CFTC's appellate position from the briefing and from oral argument. It specifically challenges these discrete aspects of the District Court's judgment: (1) the Commercial did not violate the Act; (2) the Seminar did not violate the Act; (3) Defendants had no duty to disclose their trading record to potential customers; (4) Defendants did not excessively trade their customers' accounts without regard to customer interest; and (5) Raymond Fitzgerald did not have "controlling person" liability under the Act. As explained below, we agree that the District Court erred in not finding liability as a matter of law under the Act for the Commercial, the Seminar, and for failure to disclose RJFCO's trading record in both. We further agree that Raymond Fitzgerald is liable in this case as a "controlling person" at the firm. We do not disturb the District Court's judgment as to the remaining alleged points of error.

A. The Commercial

CFTC argues that the District Court erred because the Commercial is fraudulent as a matter of law. Upon review of the full text of the Commercial, we are constrained to agree. The CEA and its accompanying regulations directly proscribe attempts to deceive and defraud in connection with futures and options trading. 17 C.F.R. § 33.10 provides:

> It shall be unlawful for any person directly or indirectly:
> (a) To cheat or defraud or attempt to cheat or defraud any other person;
>
> (c) To deceive or attempt to deceive any other person by any means whatsoever in or in connection with an offer to

> enter into, the entry into, the confirmation of the execution of, or the maintenance of, any commodity option transaction.

See also 7 U.S.C. § 6b(a)(i), (iii) (proscribing similar conduct in connection with a futures contract).

In order to establish liability for fraud, CFTC had the burden of proving three elements: (1) the making of a misrepresentation, misleading statement, or a deceptive omission; (2) scienter; and (3) materiality. *See Hammond v. Smith Barney Harris Upham & Co.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) 24,617 (CFTC Mar. 1, 1990); *CFTC v. Trinity Finan. Group, Inc.*, Comm Fut. L. Rep. 27,179 (S.D. Fla. Sept. 29, 1997), *aff'd in relevant part, CFTC v. Sidoti*, 178 F.3d 1132 (11th Cir. 1999). Failure to establish any one of these elements is dispositive and would preclude CFTC's fraud/deception claims.[6]

Whether a misrepresentation has been made depends on the "overall message" and the "common understanding of the information conveyed." *Hammond*, Comm. Fut. L. Rep. at 36,657 & n.12. For purposes of fraud or deceit in an enforcement action, scienter is established if Defendant intended to defraud, manipulate, or deceive, or if Defendant's conduct represents an extreme departure from the standards of ordinary care. *See, e.g., Messer v. E.F. Hutton & Co.*, 847 F.2d 673, 677-79 (11th Cir. 1988). In the similar context of federal securities law, we have previously stated that scienter is met when Defendant's conduct involves "highly unreasonable omissions or misrepresentations . . . that present a danger of misleading [customers] which is either known to the Defendant or so obvious that Defendant must have been aware of it." *Ziemba*

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[6] Unlike a cause of action for fraud under the common law of Torts, "reliance" on the representations is not a requisite element in an enforcement action. *See, e.g., CFTC v. Rosenberg*, 85 F. Supp. 2d 424, 446 (D.N.J. 2000).

v. Cascade Int'l, Inc., 256 F.3d 1194, 1202 (11th Cir. 2001). A representation or omission is "material" if a reasonable investor would consider it important in deciding whether to make an investment. *See Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54, 92 S. Ct. 1456, 1472, 31 L. Ed. 2d 741 (1972); *R & W Technical Servs., Ltd. v. CFTC*, 205 F.3d 165, 169 (5th Cir. 2000).

In applying these various elements to the present case, we are guided by the principle that the CEA is a remedial statute that serves the crucial purpose of protecting the innocent individual investor—who may know little about the intricacies and complexities of the commodities market—from being misled or deceived. As the Fifth Circuit recently explained in *R & W*:

> In 1974, Congress gave the [CFTC] even greater enforcement powers, in part because of the fear that unscrupulous individuals were encouraging amateurs to trade in the commodities markets through fraudulent advertising. Remedial statutes are to be construed liberally, and in an era of increasing individual participation in commodities markets, the need for such protection has not lessened.

Id. at 173 (citations omitted) (emphasis added).

The parties obviously do not contest the textual content of the Commercial. The actual words of the Commercial and how the Commercial physically appeared on television are undisputed matters of record and do not require us to second guess what the District Court concluded with regard to witness demeanor and credibility at the bench trial. That being said, we are persuaded that these undisputed facts demonstrate fraud and deception as a matter of law.

Read for its *overall message*, and how that message would be interpreted by an objectively reasonable television viewer, the Commercial overemphasizes profit potential and downplays risk of loss, presenting an unbalanced image of the two. The Commercial suggests to the potential investor,

that truly enormous profits (200-300%) can be made on options on futures contracts by looking at known and expected weather patterns. More specifically, the Commercial affirmatively represents to potential RJFCO customers that El Nino had struck "where *expected*" and that if the "*patterns continue*," "*huge* profits" of "*200 to 300%*" could be realized. The Commercial also improperly overstated the profit potential by suggesting to potential customers that they should not pass up such a tremendous chance to make money. Rather, viewers are told to call RJFCO "now" because there may "never" be such an opportunity in the corn market again. ("The potential of the corn market may *never* be greater [and] 'could be the formula for a trade *you won't want to miss.*' Find out how as little as $5,000 could translate into profits as high as 200 to 300 percent. Call R.J. Fitzgerald today."). Against these highly alluring statements is only boilerplate risk disclosure language. We agree with CFTC's position that these statements directly contravene the legal principles established in prior commodities fraud cases. *See, e.g., Trinity Finan. Group*, Comm. Fut. L. Rep. 27,179, *aff'd in relevant part, Sidoti,* 178 F.3d 1132; *In re JCC, Inc.*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) 26,080 (CFTC May 12, 1994), *aff'd, JCC, Inc. v. CFTC*, 63 F.3d 1557 (11th Cir. 1995); *Bishop v. First Investors Group*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) 27,004, 44,841 (CFTC Mar. 26, 1997); *In re Staryk*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. 27,206, 45,809 (CFTC Dec. 18, 1997). As we have indicated in various prior commodities cases, the fact that the Commercial had a general risk disclosure statement does not automatically preclude liability under the CEA where the overall message is clearly and objectively misleading or deceptive. *See Clayton Brokerage Co. v. CFTC*, 794 F.2d 573, 580-81 (11th Cir. 1986); *JCC*, 63 F.3d at 1565 n.23, 1569-70; *Sidoti*, 178 F.3d at 1136 ("we seriously doubt whether boilerplate risk disclosure language could ever render an earlier material misrepresentation immaterial.");

see also Bishop, Comm Fut. L. Rep. at 44,841. Contrary to Defendants' argument, we see no absolute, bright-line requirement in these cases that a solicitation offer a "clear guarantee[]" of profits before liability is triggered. Appellees' Brief at 40. Nor should there be. Such an exacting standard would thrust the door of deception wide open, allowing clearly misleading statements to escape CFTC enforcement, thereby thwarting the underlying purpose of the Act. Brokers would have free reign to abuse their knowledge by subtly manipulating customer beliefs about the functioning of commodities markets, afforded safe haven so long as no actual "guarantee" is made.

Having determined that the Commercial contained deceptive and misleading statements, we next consider the element of scienter. This element is also met here as a matter of law. Defendant acted recklessly with regard to the statements aired on television. This recklessness is premised on the fact that this Court and the CFTC have previously condemned attempts to attract customers by: (1) linking profit expectations on commodities options to known and expected weather events, seasonal trends, and historical highs; (2) suggesting that the commodities market can be correctly timed to generate large profits; and (3) substantially inflating option profit expectations while downplaying risk of loss. We hold that Defendant, as a federally registered professional, knowledgeable in the nuances and complexities of the industry, deviated in an extreme manner from the standards of ordinary care.

The final element, materiality, is satisfied as well. It is too obvious for debate that a reasonable listener's choice-making process would be substantially affected by emphatic statements on profit potential ("200-300%") and the suggestion that known and expected weather events are the vehicle for achieving those enormous profits. A reasonable investor would also be heavily influenced by the suggestion in the Commercial that, due to weather events, the present day offers an opportunity like no other to make money in the

corn market. *See In re JCC*, Comm. Fut. L. Rep. at 41,576 n.23 ("When the language of a solicitation obscures the important distinction between the possibility of substantial profit and the probability that it will be earned, it is likely to be materially misleading to customers."). *See also CFTC v. Noble Wealth Data*, 90 F. Supp. 2d 676, 686 (D. Md. 2000) (representations about profit potential and risk "*go to the heart of a customer's investment decision* and are therefore material as a matter of law"), *aff'd in part and vacated in part*, 278 F.3d 319 (4th Cir. 2000).

Defendants argue that scienter is lacking with regard to the Commercial because Raymond Fitzgerald edited the Commercial to include more disclosures, sought and received approval from Iowa Grain, and assured NFA official Croom that the Commercial had already been discontinued after Croom expressed concern over its misleading content. None of these arguments can overcome the CFTC's position that prior cases establish the illegality of the Commercial's content as a matter of law. Moreover, Defendants should not be able to escape liability under the Act by simply claiming that a related private business entity (Iowa Grain) issued its stamp of approval. Iowa Grain does not determine with legal finality what constitutes deceptive solicitations under the CEA and its regulations.

Defendants further argue that CFTC has not established "clear error" in the District Court's finding that the Commercial was not "deceptive or misleading," asserting that CFTC cannot possibly leap the barrier of this highly deferential standard of review. We are not persuaded. It is too well-settled for dispute that findings of fact which flow directly from the observation of witnesses at trial cannot be reversed unless clearly erroneous. But that doctrine of appellate review is not implicated here. This is not a situation where we must defer to a trial court's conclusion of fact because that conclusion rests on the unique opportunity to personally scrutinize live testimony at trial and measure credibility word by word. Rather, the precise language in the

Commercial is an undisputed part of the appellate record. The fraudulent and deceptive nature of that language is, as CFTC posits, established as a matter of law in precedent. The precise error at the district court level is definitively legal in nature: it is the failure to recognize that the outcome of CFTC's claim on the uncontested words in the Commercial is controlled by case law. *See generally Lincoln v. Board of Regents*, 697 F.2d 928, 939 (11th Cir. 1983) (if legal error taints fact finding process, *de novo* review may be used by appellate court).[7]

B. The Promotional Seminar

Much of the discussion above on the illegality of the Commercial applies to the Seminar as well. We hold that the Seminar is also fraudulent and deceptive as a matter of law. Like the Commercial, the Seminar, when viewed in its entirety, suggests to a reasonable listener that RJFCO has a reliable strategy in place for increasing profits and limiting losses.[8] Like the Commercial, it presents a distinctly unbalanced picture between the potential for profit and the potential for loss in options, inflating one while downplaying

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[7] As part of their argument that the Commercial is not deceptive, Defendants assert that investors had, in the past, actually made profits as large as 200-300%. However, just because such profits are possible, or have happened to some degree in the past, does not mean that the Commercial's total message is not misleading. *See JCC*, 63 F.3d at 1568 n.34. Even literally true statements can be extremely and impermissibly deceptive when viewed in their overall context. *See, e.g., In re Staryk*, Comm. Fut. L. Rep. at 45,809.

[8] This Circuit has clearly explained previously that brokers must be extremely careful when making representations in the commodities market because the standard *pro forma* risk disclosures do not "warn the customer to disbelieve *representations that certain trading strategies can . . . overcome inherent market risks, or that certain commodities are less volatile*. Those *unfamiliar* with the workings of markets are unlikely to understand that *no broker can eliminate or diminish risk*." *Clayton*, 794 F.2d at 580-81 (emphasis added). We note that RJFCO designed its business specifically to deal with smaller, less experienced customers. *See R.J. Fitzgerald*, 173 F. Supp. 2d at 1297.

the other. The Seminar also impermissibly suggests that profits on options on futures contracts (the specific type of investment they were promoting) are proportionally related to the cash market. *See CFTC v. Commonwealth Finan. Group, Inc.*, 874 F. Supp. 1345, 1352 (S.D. Fla. 1994), *vacated on other grounds*, Slip Op. No. 94-5182, 79 F.3d 1159 (11th Cir. 1996); *Bishop*, Comm. Fut. L. Rep. at 44,841 (deceptive to tell customer that one could earn $420 for every penny increase in heating oil); *In re JCC*, Comm. Fut. L. Rep. 26,080 (fraud to tell customer that every time sugar moves ten cents, you make $67,000); *Trinity Finan. Group*, Comm. Fut. L. Rep. 27,179 (deceptive to use cash prices to predict proportional profits on heating oil options).

Furthermore, as with the Commercial, the Seminar, in its heating oil mathematical illustration, misleads potential customers by suggesting that historical movements and known and expected seasonal patterns can be used reliably to predict profits on options. The Seminar gave those in attendance a deceptive impression that known seasonal trends will lead to their quick success and that options provide a scenario of "limited risk." In this regard, we are especially concerned with the Seminar's suggestion toward the end of the undisputed script that "greed" is a major reason people do not make money in commodities and that a customer "will *never go broke* taking a *profit*." Despite the Seminar's use of risk disclosure material, the overall impression is that RJFCO is going to make customers money if they invest in options. Such conduct simply cannot survive under the Act, its underlying purpose, its regulations, and the interpretive case law. As with the Commercial, the statements in the Seminar are clearly material because an objectively reasonable investor's decision-making process would be substantially affected by the Seminar's discussion on limited risk, cyclical heating oil-weather patterns, and examples and illustrations of large profits. Such representations, as a matter of law, alter the total mix of relevant information available to the potential commodity

option investor. Scienter is also established on this record as a matter of law for the same reasons as with the Commercial. Precedent has condemned materially similar representations in the past, including specific representations on heating oil. We hold that Defendants acted with the requisite recklessness and departed in an extreme manner from the ordinary standards of care.

C. Fraudulent Omission: Non-Disclosure of the Firm's Success Record

As explained above, CFTC contends, and we agree, that liability is established with regard to the language used in the Commercial and the Seminar. As an additional violation of the Act, CFTC claims that these two solicitation devices were fraudulent as a matter of law because they spoke of RJFCO's strategy for enormous profit potential without simultaneously informing potential RJFCO customers that more than 95% of the firm's clientele lost money in the types of investments being advertised.[9] We agree.

Given the extremely rosy picture for profit potential painted in the Seminar and in the Commercial, a reasonable investor *surely* would want to know—before committing money to a broker—that 95% or more of RJFCO investors lost money. Such a disclosure would have gone a long way in balancing out, for example, the affirmative representation in the Commercial that the grain market was ripe for "huge" profits of "200-300 percent" and to telephone RJFCO "now" because such a corn market opportunity may "never" exist again. It would also have done much to counteract the assertion of "limited risk" in the Seminar. It is misleading and deceptive to speak of "limited risk" and "200-300" percent profits without also telling the reasonable listener that the overwhelming bulk of firm customers lose money. *See Ziemba*, 256 F.3d at 1206 (duty to disclose arises where

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[9] RJFCO's principal, Raymond Fitzgerald, testified that more than 95% of Defendants' customers lost money.

a "defendant's failure to speak would render the defendant's *own* prior speech misleading or deceptive") (emphasis in original); *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1043 (11th Cir. 1986) (same); *see also Modlin v. Cane*, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) 28,059, 49,550 (CFTC March 15, 2000) ("a reasonable investor who hires a broker . . . would clearly find it material to learn that that broker had never closed an account with a profit."); W. Page Keeton et al., Prosser and Keeton on Torts § 106 at 738 (5th ed. 1984) ("half of the truth may obviously amount to a lie, if it is understood to be the whole.").[10]

In its determination that there was no duty to disclose, the District Court was influenced by the fact that there was no evidence that other firms in the commodities industry did any worse than RJFCO and that RJFCO did not affirmatively represent that it had an attractive success rate. Given the highly misleading nature of the Commercial and Seminar, we fail to discern the legal significance of those facts in this case. As CFTC has persuasively argued, the Act should not foster a "race to the bottom," where liability for unquestionably deceptive activity is based in part on whether your competitors are not doing any better than you are. The focus of the inquiry is not on how well or how poorly others firms have done or even, in some circumstances, whether a firm has affirmatively boasted about a particular win-loss record. Rather, the judicial cross hairs in this case fall squarely on what the investor would reasonably want to know before deciding to commit money to a broker. *See, e.g.*, 17 C.F.R. § 33.7(f); *Sidoti*, 178 F.3d at 1136 n.3 (explaining that § 33.7(f) "bolsters" 17 C.F.R. § 33.10 by stating that standard risk disclosures do not relieve a broker from the obligation of disclosing all material facts to potential or existing options customers). This of course

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[10] One RJFCO customer testified at trial that if he had been told during a telephone solicitation that about 96% of RJFCO customers lost money, he probably "would have hung up the phone."

brings us back, as it should, to the underlying remedial purpose of the Act: protecting the individual investor from being misled or deceived in the highly risky arena of commodities investment. The omission of highly material information is pernicious because it strikes at the very core of individual autonomy. The law vigorously protects the right of private individuals to exercise free choice in the marketplace. Such freedom of choice is eviscerated, and the autonomy of the individual severely undermined, if decision-altering information is withheld.

D. Excessive Trading of Customer Accounts

CFTC argues that the district court erred by finding that Defendants did not excessively trade client accounts without regard to client interest, in contravention of the Act. We do not agree. This "churning" claim stems from a specific trading strategy developed by Defendant Kowalski in 1998 known as "synthetic futures." The details of that strategy were sufficiently explained in the District Court, *see* 173 F. Supp. 2d at 1306-1309, and do not warrant repetition here. In order to succeed on a churning claim, CFTC had to establish that Defendants intentionally or recklessly traded client accounts in excess, without regard to client interest, and that Defendants controlled the accounts in question. *See, e.g., Patch v. Concorde Trading Group, Inc.*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) 26,253, 42,125 (CFTC Oct. 31, 1994). Unlike the Commercial and the Seminar, the churning claim is intimately connected with factual conclusions derived from witness testimony and credibility assessments made at the bench trial. For example, the requisite element of control over customer accounts in this case is an inquiry that turns upon the credit given to witnesses by the trier of fact. We have reviewed the District Court's analysis of this claim and cannot find that entering judgment in favor of Defendants on this claim was erroneous.

E. "Controlling Person" Liability under the Act

CFTC asserts that the District Court erred by finding Raymond Fitzgerald not liable as a "controlling person" under the provisions of 7 U.S.C. § 13c(b). We agree. "A fundamental purpose of Section 13b is to allow the Commission to reach behind the corporate entity to the controlling individuals of the corporation and to impose liability for violations of the Act directly on such individuals as well as the corporation itself." *JCC*, 63 F.3d at 1567 (internal quotations and citation omitted). In order to succeed on a 13c(b) claim, CFTC must show that Defendant, as a controlling person, did not act in good faith *or* knowingly induced, directly or indirectly, the conduct which constitutes a violation of the Act. To satisfy the latter standard, CFTC must show that the controlling person had actual or constructive knowledge of the core activities that make up the violation at issue and allowed them to continue. *Id.* at 1568. Section 13c(b), therefore, is about power, and imposing liability for those who fail to exercise it to prevent illegal conduct.

Applying this legal standard to the record, we conclude that Raymond Fitzgerald meets the criteria for 13c(b) liability. First, we note that Raymond Fitzgerald openly *concedes* that he was a "controlling person" at RJFCO. Appellees' Brief at 62. Raymond Fitzgerald was RJFCO's principal and exercised the ultimate choice-making power within the firm regarding its business decisions. *See* 173 F. Supp. 2d at 1297. He reviewed and approved the activities that we hold today violated the Act and its regulations—the Seminar and the Commercial. He was ultimately responsible for compliance with all applicable rules on commodities solicitations. He had the power and the authority to prevent the Seminar from being conducted, or to alter its content to comply with extant law.

IV. CONCLUSION

This case serves as a pungent reminder that *caveat emptor* has no place in the realm of federal commodities fraud. Congress, the CFTC, and the Judiciary have determined that customers must be zealously protected from deceptive statements by brokers who deal in these highly complex and inherently risky financial instruments. Upon review of the record and controlling law, we conclude that the District Court erred in finding that the Commercial and the Seminar did not violate the CEA and its regulations. Both were deceptive and misleading, unquestionably material to the potential customer, and promulgated with the requisite scienter. These two solicitation devices also violate the Act because they failed to disclose extremely material information that any reasonable investor would want to know before committing money.

Raymond Fitzgerald is liable for the Commercial and Seminar under 7 U.S.C. § 6c(b) and 17 C.F.R. § 33.10. Leiza Fitzgerald is liable for her involvement with the Seminar under § 6c(b) and § 33.10. For purposes of this CEA violation by Leiza Fitzgerald, Raymond Fitzgerald is a controlling person and is liable under § 13c(b). RJFCO is liable for the individual violations of Raymond Fitzgerald and Leiza Fitzgerald pursuant to 7 U.S.C. § 2(a)(1)(B). As to all other Defendants, we will affirm the order of the District Court. We remand the matter for enforcement proceedings on the above violations by Raymond Fitzgerald, Leiza Fitzgerald and RJFC). To the extent that we did not discuss other points of error raised by CFTC or by Defendants, we deem them without merit. Each party to bear its own costs.

TJOFLAT, Circuit Judge, concurring:

I write separately only to underscore the extent of the misrepresentations committed by the defendants and to make a broader point about "clarity"—the two issues most troubling the dissent.

One particular passage in the dissent contains the essence of the dispute in this case: "The fact of the matter is, in options, you are either going to lose big or win big—that is why brokerage firms like RFJCO can advertise potential profits of up to 200 to 300% and must also warn that this type of investment involves a high risk of loss (only investment capital should be used)." The dissent evidently feels that by proclaiming that only "investment capital should be used," together with an equally generic disclaimer, a reasonable investor should be put on notice that commodities trading is extraordinarily volatile and the risk of loss enormous. Recognizing that "commodities brokerage firms need to disclose both the potential and risks involved in options trading," the dissent concludes that "RFCO does just that—disclosing the appropriate amount of profit potential as well as the adequate amount of risk."

The crux of my disagreement with the dissent, then, lies in the necessary congruence between claims of potential profit and the concomitant risk involved. The dissent evidently believes that commodities brokerage firms can advertise about enormous profits (replete with constant repetition, explanation points, and satellite photographs of hurricanes) while making brief mention of the risk involved—a discussion of risk sugar-coated with assertions about how this risk can be "limited" while still providing "unlimited profit potential." In my view, such lopsided advertising is hardly a disclosure of the "the adequate amount of risk" as the dissent proclaims. It certainly failed to convey the *magnitude* of the risk involved (remember: 95% of the firm's clientele lost money on the advertised investments).

The deception regarding the substantial *risk* was compounded with more deception about how, precisely, the potential *gains* were going to be realized. The discussion about El Nino and urgency in the timing of the investment created an air of inevitability—as if the defendant had some special knowledge with which to exploit an asymmetry of information in the market. All of this is fine, the dissent

argues, so long as the advertiser skirts the line by peppering his language with conditional language ("could" and "may") and does not say that profits are *absolutely* inevitable. Viewed from the perspective of a reasonable investor—not an investment banker at Merrill Lynch or a futures specialist for ADM[1]—a misleading expectation of investment success can certainly be made even if conditional language is used. This misleading picture is exactly the sort that the defendants painted. Perhaps the dissent would rather have a world of *caveat emptor*: "If it is the case that investors '*surely*' wanted to know [information about the past success of the defendants' clients] before they invested, then why didn't they ask?" says the dissent. But this is not the world Congress envisioned when it enacted the commodities laws.

The dissent further bemoans the lack of clarity in the law. While it is undoubtedly true that the terms chosen by Congress—"defraud" and "deceive"—lack the precision necessary to guide behavior in all transactions, this "problem" is a necessary byproduct of the inherent difficulty in legal drafting. Language of general applicability—the stuff of statutes and common law rules—is simply incapable of conveying the entire range of permissible and impermissible conduct. The law is replete with nebulous phrases such as "proximate cause" and "rule of reason." Some cases may entail *post hoc* judicial refinement, resulting in the unavoidable problem of a civil defendant without notice that his precise conduct could result in liability.

Whatever problems may be created by nebulous rules, I am confident that in this case, the defendants had ample notice that their heavily unbalanced portrait of options trading—a picture far different from reality—was impermissible. When an investor seeks to invest his money, he is principally concerned with two factors: return and risk. A

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[1] The advertisement in this case was obviously aimed at the novice commodities investor.

rational investor with no peculiar aversion to risk would be indifferent between having $5 and a one-in-ten chance at winning $50. Change the risk factor to one-in-eighty and the bet becomes unattractive even to the most risk-seeking individual. The defendants in this case knew that by trumpeting enormous returns and downplaying the risk involved, a reasonable (if unsophisticated) investor would be enticed to make a bet that he would not otherwise make were the full picture disclosed. As the majority opinion points out, "it is misleading and deceptive to speak of 'limited risk' and '200-300' percent profits without also telling the reasonable listener that the overwhelming bulk of firm customers lose money." Don't make an active attempt to instill in the investor a grossly inaccurate picture of the risk-to-reward ratio. That is the rule in this case—a rule I find to be abundantly clear.

WILSON, Circuit Judge, dissenting:

I am troubled by the majority's holding, because it provides no useful guidance to commodities brokerage firms as to how to bring their solicitation and advertising activities into compliance with the law. Our case law already contains a confusing and vague definition of what constitutes "fraud" under the Commodities Exchange Act (CEA) and Commission Rule 33.10; the majority's opinion only adds to the uncertainty of this body of law. On this record, I would have found that R.J. Fitzgerald & Co. (RJFCO) was not involved in fraudulent solicitations, nor did they attempt to cheat, defraud, or deceive clients under Commission Rule 33.10. Therefore, I respectfully dissent.

DISCUSSION

The majority contends that the statements made by RJFCO in the commercial and the promotional seminar "directly contravene the legal principles established in prior commodities fraud cases." The majority cites the following four cases to support its finding that RJFCO committed fraud: (1) *CFTC v. Trinity Fin. Group, Inc.*, [1996-1998

Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,179 (CFTC Sept. 29, 1997), *aff'd in relevant part and vacated in part*, *CFTC v. Sidoti*, 178 F.3d 1132 (11th Cir. 1999); (2) *In re JCC, Inc.*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,080 (CFTC May 12, 1994), *aff'd*, *JCC, Inc. v. CFTC*, 63 F.3d 1557 (11th Cir. 1995); (3) *Bishop v. First Investors Group of the Palm Beaches, Inc.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,004 (CFTC Mar. 26, 1997); (4) *In re Staryk*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,701 (CFTC June 5, 1996), *aff'd in relevant part and vacated in part*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,206 (CFTC Dec. 18, 1997).

A comparison of the facts of these four cases to the facts in this case should lead to the conclusion that RJFCO's statements are dissimilar and legally distinguishable from all four cases.

I. RJFCO DID NOT FALSELY MISREPRESENT PROFIT POTENTIAL OR CLAIM THAT SEASONAL TRENDS PRACTICALLY GUARANTEED PROFITS.

It is clear from prior case law that a broker registered as an associated person (AP) must not misrepresent the likelihood of profit to any current or prospective customer. *See, e.g., In re JCC, Inc.*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 41,576; *In re Staryk*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 45,809. As the commission in *In re JCC, Inc.* stated, "[w]hen the language of a solicitation obscures the important distinction between the *possibility* of substantial profit and the *probability* it will be earned, it is likely to be materially misleading to customers." [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 41,576 n.23 (emphasis added). More specifically, an AP must not represent that an anticipated seasonal trend, such as winter and summer, will "almost guarantee profits." *Sidoti*, 178 F.3d at 1135-36.

For example, the APs in *Trinity Financial Group, Inc.* "misrepresented the profit potential of . . . commodity options by falsely telling . . . customers that they were practically guaranteed to make a profit because of the cyclical and/or seasonal nature of the gasoline and heating oil markets." [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 45,628. One AP told a customer "that heating oil was cyclical in nature and that this was a pattern that he had seen over the past ten years, and that he had consistently made money on it." *Id.* Another AP said that "heating oil *always* went up during the winter and that if he invested $10,000, he would make $60,000 to $70,000 by the end of the year." *Id.* Yet another AP said that in the heating oil market "the trend is to buy in the summer months and sell it in the winter months. And he made the analogy, . . . when do you buy a fur coat? Do you buy a fur coat in the winter months or do you buy it in the summer months?" *Id.*

In *In re JCC, Inc.*, the scripts given to the APs "often emphasized historical market moves that earned customers substantial profits, and encouraged customers to anticipate similar profits." [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 41,576. For example, one customer related that an AP told him that

> I should purchase a position in heating oil, that it was a sure thing that every Fall heating oil goes up. It was guaranteed that I'd make $3,000 by Spring, no ifs, ands, or buts. It was a sure thing. . . . After [the heating oil losses], he called me with the same story about crude oil and that time I was going to make $8,000.

Id. The commission in *In re JCC, Inc.* held that,

> [g]iven the distorted view of the likelihood of profit and loss fostered by the blatant misrepresentations discussed above, such history-based statements do not escape our scrutiny merely because such a profit was possible, indeed, had actually been earned at a particular historical point . . . Without additional historical context, such as

> the frequency of the described market movement and whether market fundamentals or related circumstances have changed since the last occurrence, and some cautionary language about the difficulty of catching a market trend and escaping its reversal, customers can be misled by undue emphasis on such historical successes. In the circumstances of this case, we find that JCC and EDCO's focus on such successes helped deceive their customers about the fundamental nature of the futures markets.

Id.

In *Bishop*, the customer was induced into opening an account as a result of an AP's statements that based upon the history of the heating oil market, profits were "*probable.*" [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 44,841. The AP said that "based on the history of the heating oil market for the past 12 years, I could make a lot of money in heating oil. . . . [P]eople had made a lot of money buying before prices rose and selling after they had risen." *Id.* The commission found that "[t]hese types of representations made by [an AP] provide the deceptive message that the predictable nature of the seasonal demand and price trends essentially assured the likelihood of dramatic profits and far outweighed the risk of loss generally associated with trading commodity options." *Id.* What made the AP's statements so deceptive as to be "misleading half-truths" was the fact that the AP "failed to disclose that a seasonal increase in the demand for heating oil would not necessarily result in the increased value of a heating oil option, because the market had already factored seasonal demand into the price of an option." *Id.*

Lastly, in *In re Staryk*, an AP represented to his clients that "given the historical seasonal pricing trends in gasoline and heating oil, speculation in gasoline and heating oil options is significantly less risky and more likely to result in profits than speculation in those options tied to non-seasonal

markets." [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 43,928. In fact, the AP claimed to customers that "the likelihood of the gasoline market going down in the summer is similar to the likelihood that someone would cancel the Fourth of July, cancel Memorial Day, or cancel summer vacations in schools in North America and in Europe." *Id.* at 43,929. The administrative law judge determined that those representations were "blatantly false":

> seasonal shifts in demand (and the corresponding price changes) that generally characterize the physical markets for gasoline and heating oil, do not reduce the risks involved in trading energy options. No advantage is gained from knowledge of these seasonal patterns. . . .
>
> . . . It is only when unexpected events occur, including higher or lower than expected demand for gasoline, that an option may become profitable.

Id. at 43,930-31.

After reviewing these four cases, it is clear that RJFCO does not overstate the likelihood of profit or make claims that expected seasonal trends, compared to non-seasonal trends, will practically guarantee profits. The RJFCO commercial specifically focuses on El Nino, the effects of which one can hardly say were highly expected and predictable. RJFCO states that "[d]roughts, floods and other adverse conditions could dramatically alter the supply and demand dynamics of the corn market." Not only did El Nino have an unanticipated effect on the corn market compared to other seasonal trends in other commodities markets, but this weather phenomenon also had no history that RJFCO APs could utilize to boast of previous profits. This is contrary to the bold statements made by the APs in *Trinity*, who bragged that they had consistently made money on the heating oil market, or the APs in *In re JCC, Inc.*, who claimed that every fall heating oil goes up.

Nor does RJFCO's promotional seminar focus on anticipated, historical seasonal trends. In fact, the seminar

script focuses on unanticipated trends such as abnormal weather phenomena (such as Hurricane Andrew, a drought, and floods), political conditions (specifically August of 1990 and the impending Gulf War), and new technical, hypothetical models (in which "[t]echnical analysts use trading volume and price study along with charts or computer programs to identify and project trends in the market"). Even when the script discusses the potential for profit in the heating oil market, RJFCO does not claim that the fluctuations in the demand for heating oil in the summer and winter will increase or decrease the price of an option or futures. Instead, the seminar focuses on unexpected events that may affect supply, such as storage facilities being depleted, pipelines being destroyed in Colombia and Northern Iran, and political events, such as the President of the United States dispatching the USS Nimitz to the Middle East.

The majority also contends that "the [s]eminar also impermissibly suggests that profits on options (the specific type of investment they were promoting) are proportionally related to the cash market." However, stating that profits on options is proportionally related to the cash market is not necessarily fraud. In fact, it is only when the AP asserts a one-for-one or greater correlation between profits and movements in the cash price of the commodity that fraud exists. *See CFTC v. Commonwealth Fin. Group, Inc.*, 874 F. Supp. 1345, 1352 (S.D. Fla. 1994), *rev'd in part and vacated in part*, 79 F.3d 1159 (11th Cir. 1996) (unpublished table decision). RJFCO followed the Chicago Board of Trade's example. The Chicago Board of Trade's options manual explains that "a one-cent change in the futures price would result in only a half-cent change in the option premium." Therefore, when RJFCO explains in its script that by using an option, a twenty-two cent move in heating oil "could be 50-75% of the profit that the future would have earned," RJFCO is assuming that a one-cent change in the futures price would result in only a half-cent change in the futures

price. As the equation concludes, the script provides: "Now remember that profit is on a futures contract, and if you had a less aggressive option, because you want limited risk so you would receive *50%* of that profit—46200 divided by 2 equals $23,100." RJFCO never asserts that profits on options directly move in relation to the cash market for the commodity.

II. RJFCO DID NOT DOWNPLAY OR MINIMIZE THE DEGREE OF RISK INVOLVED IN INVESTING IN COMMODITY OPTIONS.

Clayton Brokerage Co. of St. Louis v. CFTC, 794 F.2d 573, 580 (11th Cir. 1986) (per curiam), tells us that "[t]he extent of disclosure necessary to provide full information about risk will vary depending on the facts and circumstances of trading as well as on the nature of the relationship between the broker and the customer." This standard leaves a lot to be desired and provides courts with a significant amount of discretion as to what constitutes sufficient disclosure of risk. However, several cases, including *Sidoti*, *In re JCC, Inc.*, and *In re Staryk*, provide us with some guidance as to how this standard is to be applied.

The majority extends the principles of law articulated in these cases into a set of facts where these principles should not apply. It reaches overly broad conclusions, such as "the Commercial overemphasizes profit potential and downplays risk of loss," and "[the seminar] presents a distinctly unbalanced picture between the potential for profit and the potential for loss in options, inflating one while downplaying the other," without grappling with the particular set of facts involved in the instant case. These conclusions are not supported by this record, nor is the legal standard underlying them supported by our precedent.

In *Clayton Brokerage Co. of St. Louis*, APs made affirmative misrepresentations as to risk; customers were told to "ignore the risk disclosure statement," "that certain trading strategies can limit losses," and "that the broker's

scheme can overcome inherent markets risks, or that certain commodities are less volatile." *Id.* at 580-81.

In *Sidoti*, the APs downplayed the degree of risk by telling customers that the risks of trading "commodity options were non-existent or minimal." 178 F.3d at 1135-36.

In *JCC, Inc.*, former APs testified that they were taught "to minimize risk, . . . to characterize the $2500 management fee as insignificant compared to potential profits, and to use the Regulation 1.55 risk disclosure statement as a sales tool by explaining away various paragraphs of the document as inapplicable to the FLT program." 63 F.3d at 1568. Customers were told that "they could lose no more than $500 in the sugar market," "that foreign currencies were much safer than grain trading because of the guarantees of the movements in the currencies," and that "we actually had very little risk at all." *In re JCC, Inc.*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 41,576.

In *In re Staryk*, although the AP would disclose risk, he would always downplay it by emphasizing the predictability of the price fluctuations in gasoline and heating oil. [1994-1996 Transfer Binder] Comm. Fut. L. Rep.(CCH) at 43,929. The administrative law judge determined that although the AP "remind[ed] customers that past performance may not guarantee success in the future, this generic warning of risk is almost always juxtaposed with information and statements which convey that this risk is in fact small." *Id.*

The disclosures of risk that were employed in *Clayton Brokerage Co. of St. Louis*, *Sidoti*, *In re JCC, Inc.*, and *In re Staryk* are distinguishable from the risk disclosures provided by RJFCO in the instant case.[1] In its television commercial,

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[1] It is worth noting that the seven customers who testified against RJFCO acknowledged that they understood the level of risk involved in trading commodities. Several of these customers either maintained/traded stock and mutual fund investments or studied commodity futures. Most of RJFCO's customer base consisted of people who had themselves first inquired into commodity trading; they were not sought out.

RJFCO attempted to explain the risk to potential customers in four separate ways. The first, most obvious risk disclosure statement made by RJFCO was the statement found on the bottom one-fourth of the screen, which was kept on the screen for forty-five of the sixty seconds of the commercial's running time. This statement, displayed in bold capital letters directly above RJFCO's phone number, provided: "OPTIONS INVESTING INVOLVES A RISK OF LOSS. MINIMUM ACCOUNT $5,000." Any viewer who jotted the phone number down would have seen the prominent risk disclosure statement displayed above the number.

The second disclosure statement flashed on the screen three seconds after the commercial began. It provided in bright yellow letters: "The preceding were hypothetical mathematical samples of leverage in the Commodity Options Market." This disclosure clarifies the point that RJFCO's prediction was based upon a hypothetical that is not guaranteed to come true.

Third, and perhaps most important, the commercial is filled with conditional language—nothing is guaranteed. RJFCO is equivocal in its advertising—none of the language in the commercial suggests that El Nino *will definitely* affect the corn market as predicted and that customers *will* receive huge profit. Rather, the following conditional statements were made: "[El Nino's] effect on world crops *could* mean huge profits in the grain markets." "Conditions *may* exist for profits as high as 200 to 300 percent." "[*I*]*f* patterns continue, the effects *could be* devastating," and "adverse

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It was also determined at trial that all seven of these customers received and had an opportunity to review the risk disclosure booklet before opening an account. The risk disclosure booklet explained the amount of risk involved in options trading. The customers were also advised that only risk capital should be invested in this kind of market. And each customer approved every trade before any trade was placed by an RJFCO AP.

conditions *could* dramatically alter the supply and demand dynamics."[2]

And finally, in the middle of the commercial, the announcer changes his tone (the voice drops) and we hear, "[*o*]*ption investing involves a high risk of loss and only risk capital should be used*." The concurring opinion suggests that this disclosure is inadequate to state the risk. How much more warning is required than a disclosure that the investment is a "*high risk*"? This flagrant risk disclosure statement, which is hardly brief within the format of the commercial, combined with the "RISK OF LOSS" statement conspicuously prominent on the screen throughout almost the entire commercial, the other statement explaining RJFCO's mathematical formula, and the conditional language placed throughout the commercial, effectively and sufficiently discloses the magnitude of risk involved.

As for the promotional seminar, once again I find that there is an adequate amount of risk disclosure. One need only compare the seminar with the National Futures Association's (NFA's) manual[3] to see that RJFCO thoroughly disclosed risk according to the NFA's suggestions.

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[2] RJFCO's chief market analyst studied the various commodities markets and developed a reasoned trading strategy. RJFCO's trading strategy was based on, as the district court found, "deliberate research and logical assumptions and the strategy was developed primarily to yield profit for RJFCO clients, not simply to generate commissions." *CFTC v. R. J. Fitzgerald & Co.*, 173 F. Supp. 2d 1295, 1307 (M.D. Fla. 2001). Numerous reports from a variety of prominent and respected financial and meterological sources were examined to develop the strategy predictions.

[3] The NFA's manual, which was admitted into evidence at trial and is part of the record on appeal, provides an introduction to options on futures contracts, how they work, and the opportunities and risks associated with their purchase. The NFA is a self-regulatory organization in the futures industry.

For example, RJFCO's promotional seminar provides: "In contrast to futures, options on futures allow investors and risk managers to define risk and limit it to the loss of a premium paid for the right to buy or sell a futures contract, while still providing the buyer with unlimited profit potential." The NFA manual provides:

> For the individual who has a price opinion (that a particular futures price will change by at least some given amount in a certain direction within a specific period of time), buying options offers the opportunity to realize substantial profits with a predefined and limited risk. The maximum an option buyer can lose—should events prove him wrong about the direction, extent or timing of the price change—is the premium paid for the option plus commissions and other transaction costs.[4]

The majority takes exception to the following assertions regarding unlimited profit potential and limited risk in options found in RJFCO's seminar: "If you are highly aggressive and looking for unlimited profit potential as well as unlimited risk than [sic] it would be the futures. But most would like something less aggressive, something offering unlimited profit potential but limited risk-option trade." The NFA manual confirms this for it provides: "[U]nlike an option which has limited risk, a futures position has potentially unlimited risk."

Now, if the "limited risk with unlimited profit potential" had been "recited repeatedly as a sales inducement," then these true statements could have become fraudulent in that the representation begins to "inflate the *likelihood* of profit

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[4] This explains that RJFCO's calculations in its profit illustration that the majority claims are false—"Now remember that profit is on a futures contract, and if you had a less aggressive option, because you want limited risk so you would receive approximately 50% of that profit—46200 divided by 2 equals $ 23,100"—are actually possible according the NFA's manual. A less aggressive option on a futures contract does create limited risk.

while minimizing the risk of loss." *In re Staryk,* [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 45,809. That, however, is simply not the case here—the seminar does not overemphasize profit and downplay risk of loss. Rather, the introduction to the seminar provides, "These markets are risky—we want you to go away with ideas on how to limit your risk but still be positioned to take advantage of the volatility that not only make them exciting but potentially very profitable." RJFCO actually mentions loss *first*, noting how options on futures contracts can limit this risk, and *then* mentions potential profit (not guaranteed or probable profit). Practically every affirmative representation on profit is counterbalanced with a risk warning. ("Past price action can provide you with clues to future action. The market is anticipatory, and you can see price movement first in the chart for the day." The next paragraph then warns: "Chart signals, just like fundamental news can be misleading. You should have structure in you[r] approach to the markets.")

Since I find no misleading or deceptive statements made by RJFCO in its commercial or seminar, there is no need to examine scienter and materiality. However, it bears mentioning that the majority found RJFCO to have "acted recklessly with regard to the statements aired on television." The majority based this recklessness

> on the fact that this Court and the CFTC have previously condemned attempts to attract customers by: (1) linking profit expectations on commodities options to known and expected weather events, seasonal trends, and historical highs; (2) suggesting that the commodities market can be correctly timed to generate large profits; and (3) substantially inflating option profit expectations while downplaying risk of loss.

I find no prior precedent supporting these contentions. At the most, these statements are oversimplifications of prior cases. Linking profit expectations on commodities options to known seasonal trends is only fraud if the AP "almost

guarantees profits," as in *Sidoti*, or "distorts the likelihood of profit," as in *In re JCC, Inc.* Suggesting that the commodities market can be correctly timed to generate profits is not necessarily fraud when, as stated in *In re Staryk*, "[i]t is only when unexpected events occur, including higher or lower than expected demand for gasoline, that an option may become profitable." [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 43,931. And the majority's buzz phrase, "substantially inflating option profit expectations while downplaying risk of loss," is much too vague and abstract a standard to be of any use to commodities brokerage firms who wish to advertise their services in the future.

The difficulty with the current standard for commodity options fraud is that Rule 33.10 is too vague. According to the majority opinion, in order to establish a fraud claim in an enforcement action under the CEA, the CFTC must prove: "(1) the making of a misrepresentation, misleading statement, or a deceptive omission; (2) scienter; and (3) materiality."[5] Therefore, much of the case law from this standard has been both arbitrary and conflicting. Additional guidelines must be introduced to further clarify the elements of fraud under Rule 33.10.

Courts have had the most difficulty in determining what constitutes a material misrepresentation or a material omission. According to the majority opinion, "whether a misrepresentation has been made depends on the 'overall message' and the 'common understanding of the information conveyed.'" As for materiality, a statement is considered material if "there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision." *Saxe v. E.F. Hutton & Co.*, 789 F.2d

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[5] While customer reliance on the misrepresentation need not be proven in a CFTC enforcement action alleging fraud, it is essential to restitution relief sought to compensate the injured party. *CFTC v. Rosenberg*, 85 F. Supp. 2d 424, 447 (D.N.J. 2000).

105, 111 (2d Cir. 1986). Unfortunately, Rule 33.10 and case law do not provide adequate guidance to either the CFTC or commodity futures brokerage firms.

While every claim of commodities fraud must be reviewed on a case-by-case basis under the existing standard, a more specific interpretation of the elements under Rule 33.10 would create a standard whereby "material misrepresentations or material omissions" would be more readily discernible.

What constitutes a "material misrepresentation"?

(1) The most obvious material misrepresentations are outright falsehoods told by brokerage firm APs and sales staff to prospective or current customers. Examples of blatant material misrepresentations include promising to open a trading account and not doing so, reporting erroneous account balances, or making unlawful trades in a customer's account without his or her authorization. *See CFTC v. Muller*, 570 F.2d 1296, 1300-01 (5th Cir. 1978) (finding evidence sufficient to support an injunction because AP lied concerning opening of bank account and supplied fictitious options trade statements). A material misrepresentation also occurs if an AP lies about the amount of profits earned, or losses accrued, in a customer's trading account. *See CFTC v. Rosenberg*, 85 F. Supp. 2d 424, 447 (D.N.J. 2000) (finding fraud because the AP reported trading profits when no profits had been earned and failed to report losses on trades he was not authorized to make).

(2) A material misrepresentation that is not patently obvious, but just as damaging, exists when a brokerage firm deliberately overstates profit potential and conceals the possibility of loss. Any prediction or recommendation must have a reasonable basis in fact and should be explicitly labeled just that—a prediction and not a guarantee. A statement regarding potential profits that could be earned should not be considered a material misrepresentation or

misleading statement if it is possible that these projected earnings could realistically occur.

For example, RJFCO informed customers of the potential for profits up to 300% if the El Nino atmospheric disturbances occurred as projected. If this profit potential was attainable, and RJFCO compiled significant research which suggested climactic conditions created by the El Nino phenomenon could create drought and thereby increase the price of grain due to its scarcity, then RJFCO's marketing strategy did not represent a material misrepresentation.

Existing case law reflects situations, unlike RJFCO, where other firms made unwarranted profit predictions which were considered to be inherently fraudulent due to an absence of technical research or proof to back up these claims. *See CFTC v. J.S. Love & Assocs. Options, Ltd.*, 422 F. Supp. 652, 660 (S.D.N.Y. 1976); *In re British Am. Commodity Options Corp.*, Nos. 76-15 and 77-3 (C.F.T.C. Dec. 2, 1977), noted in [1977-1980 Transfer Binder] Comm. Fut. L. Rep. ¶ 20,526 (C.F.T.C. Dec. 2, 1977), avail. on Westlaw FSEC-Admin. DATABASE, 1977 WL 13558, at *11-12.

(3) Also, any claim about a brokerage firm's past trading record or an AP's puffing of past successes should be based upon actual trades executed in the market place and should fairly represent results achieved for those periods. *CFTC Interpretative Letter* No. 77-16 [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,498, 22,065 (Oct. 18, 1977); *see Clayton Brokerage Co. of St. Louis*, 794 F.2d at 575 (finding fraud when AP boasted of his successes and none of his failures); *Commonwealth Fin. Group, Inc.*, 874 F. Supp. at 1353 (where salespeople misrepresented the past success of themselves and their firm by telling prospective customers that current clients have "recently doubled their money" and that the firm "has the best track record in the industry and has made millions of dollars in profits for their customers with little risk").

What constitutes a "material omission"? Omissions of material fact are rarely transparent and perhaps more subject to questionable interpretation than even material misrepresentations.

For example, a brokerage firm must disclose to potential and current customers the amount of risk inherent in commodity futures and options trading. However, an undefined, grey area exists between no disclosure and full disclosure. If there is no mention of risk on the part of the brokerage firm, then a material misrepresentation exists—options trading is a risky business, and customers need to be told about the possibility of losing their entire investment. The mandatory risk disclosure statement required by the CFTC puts the customer on notice of the risks of trading; however, in some instances this disclosure statement is contradicted by oral representations made by APs who tell customers to disregard this statement. *See Clayton Brokerage Co. of St. Louis*, 794 F.2d at 580; *In re JCC, Inc.*, 63 F.3d at 1568 (where the risk disclosure statement was explained away as "inapplicable"); *but see Puckett v. Rufenacht, Bromagen & Hertz, Inc.*, 903 F.2d 1014, 1019 (5th Cir. 1990) (finding that the written risk disclosure statement was sufficient enough to inform the Pucketts of the risks involved because Dr. Puckett, an educated and successful businessman who had traded securities for more than thirty years, was capable of understanding the risk disclosure statement, and admitted that he affirmatively sought risk in order to make profits).

Therefore, in order to avoid any misunderstanding or charges of misrepresentation, it would be preferable for brokerage firms to err on the side of caution and provide both written and oral disclosure statements to potential investors. If not, these firms may leave themselves open to charges that they fraudulently omitted material statements regarding risk of loss. *See CFTC v. Crown Colony Commodity Options, Ltd.*, 434 F. Supp. 911, 916 (S.D.N.Y. 1977) (holding that the commodity options sales

presentations at issue were fraudulent because they "conveyed the distinct impression that extraordinary short-term profits were all but certain to be realized by investors" and because the mechanics of commodity options trading were misrepresented).

These guidelines are merely suggestions, on my part, on how to both interpret the existing standard and provide the commodities industry with additional safeguards to ensure the legality of their sales presentations, promotional seminars, and conduct while maintaining their customers' trading accounts.

III. RJFCO HAD NO AFFIRMATIVE DUTY TO DISCLOSE ITS TRADING RECORD.

The majority implies in its opinion that RJFCO had a duty to disclose its previous track record to prospective customers. However, the majority fails to point to any prior authority that suggest that there is a specific affirmative duty on the part of a commodities brokerage firm to disclose its prior track record. The cases in the majority opinion suggest that a duty to disclose arises *only* if the firm's statements would be misleading or deceptive if it did not disclose its track record. *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1206 (11th Cir. 2001) (We recognize a duty to disclose when "a defendant's failure to speak would render the defendant's *own* prior speech misleading or deceptive"); *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1043 (11th Cir. 1986) ("[A] defendant's omission to state a material fact is proscribed *only* when the defendant has a duty to disclose") (emphasis added). Simply put, there is no mandatory duty to disclose.

The majority argues that a reasonable investor would "*surely*" want to know how many RJFCO investors had lost money, and, therefore, it was RJFCO's duty to tell them. If it is the case that investors "*surely*" wanted to know this information before they invested, then why didn't they ask? This is not a case where the APs misrepresented the firm's

track record or lied about successes in the past. *See Modlin v. Cane*, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,059 at 49,549-50 (CFTC Mar. 15, 2000) (The AP told customers "his method of trading was successful" and was "the key to making money," and "that he would jump into the East River if he was unable to generate a profit."). RJFCO never made any bold misrepresentations regarding its prior track record and, therefore, was under no duty to disclose its record.

CONCLUSION

Commodities brokerage firms need to disclose both the profit potential and risks involved in options trading. RJFCO does just that—disclosing the appropriate amount of profit potential as well as the adequate amount of risk.

Trading options on futures contracts is *inherently risky*. The fact of the matter is, in options, you are either going to lose big or win big—that is why brokerage firms like RJFCO can advertise potential profits of up to 200 to 300% and must also warn that this type of investment involves a high risk of loss (only risk capital should be used).

Admittedly, under *Sidoti*, *In re JCC, Inc.*, *Bishop*, and *In re Staryk*, the standard for fraud is vague. However, these cases at least provide a sensible set of guidelines for brokerage firms to follow in designing their solicitations and advertising programs. Essentially, these cases suggest that brokerage firms must not misrepresent or guarantee profits, nor minimize the degree of loss. However, in this case, the majority has extended the standard to apply to a situation where a firm did not misrepresent or guarantee profits and in fact disclosed the amount of risk involved.[6] And the majority opinion simply fails to offer any useful guidance to actors in this area of the law.

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[6] No customer suffered a loss beyond his or her initial investment.

Commodities brokerage firms should be on the alert—this decision may make it difficult to advertise and solicit business in the future. It is uncertain what subsequent advertising language may "overemphasize profit and downplay risk of loss." I dissent.

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF FLORIDA
TAMPA DIVISION

COMMODITY FUTURES TRADING COMMISSION,	)	
Plaintiff,	)	
v.	)	Case No. 8:99-cv-1558-T-MSS
R.J. FITZGERALD & CO. INC.; et al.,	)	
Defendants.	)	

ORDER

This case was tried on February 26 - March 19, 2001[1]. The court has reviewed the parties' submissions the evidence and testimony presented at trial, as well as the designated exhibits. Pursuant to Fed. R. Civ. P. 52, the Court makes the following findings of fact and conclusions of law.

FINDINGS OF FACT THE DEFENDANTS

1. R.J. Fitzgerald & Co., Inc. was a full-service introducing broker during all times relevant to the allegations brought here. It was guaranteed[2] by futures and commodities merchant, Iowa Grain beginning in 1992 and at all relevant periods. R.J. Fitzgerald & Co., Inc. ("RJFCO")

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[1] The parties consented to proceed before the Magistrate Judge pursuant to Title 28, United States Code, Section 636(c) and Fed. R. Civ. P. 73.

[2] As the registered futures commission merchant, Iowa Grain accepts orders to buy or sell futures contracts or options on futures and accepts money or other assets from customers to support such orders. Additionally, Iowa Grain guarantees performance by RJFCO with respect to the solicitation of and transactions involving customers and foreign options customer accounts of the introducing broker.

was opened in November 1992 and unquestionably opened as a successful introducing broker from 1992 until at least 1998. It operated as a legitimate business whose primary market focus was to serve small accounts customers with relatively little experience in the commodities market.

2. Raymond James Fitzgerald was at all times the sole shareholder, owner and operator of RJFCO. He was principally responsible for all decisions, actions, and trading recommendations made or entered into by the firm. He expressly approved by his endorsement virtually all trades entered by brokers on behalf of clients of the firm.

3. Leiza Fitzgerald was not a principal, shareholder officer, owner or operator of RJFCO at any time, nor was she responsible for any supervisory duties during her several absences due to illness, accidents, pregnancy complications, childbirth and sick leave. When she was not on leave, her responsibilities were limited to the preparation of training materials and for training the sales brokers. She diligently sought and obtained approval of RJFCO's training materials from Iowa Grain compliance officers.

4. Greg Burnett was an associated person ("AP") with RJFCO holding both a Series 3 and Series 30 license. His responsibility was primarily to supervise the broker/traders. His supervisory experience was extensive though mostly limited to the securities market. Prior to joining RJFCO, Burnett was employed as a registered representative with the firm F.N. Wolf and held both Series 7 and Series 62 licenses. Burnett next went to the securities firm Olde Financial, where he started as a registered representative and was promoted up the ranks to registered representative in charge, branch manager, and, ultimately, to regional manager over seven branch offices. His responsibilities included broker hiring, compliance monitoring and audits, trade approvals, suitability determinations and branch office audits. Throughout his career in securities, he dealt with the options market extensively. During his tenure at Olde Financial he

obtained his Series 24 (NASD principal's license) and Series 8 licenses (Branch Manager license) and received all the compliance training attendant with such licensure. After resigning from Olde due to personal problems, Burnett briefly did consulting work, for Morgan Stanley Dean Witter, on compliance issues. His next post was as trading supervisor for RJFCO, where he approved trade tickets, monitored telephone calls, directly observed the traders and eventually managed client accounts. During his tenure at RJFCO he held both the Series 3 and Series 30 licenses, and as part of his training for RJFCO, he spent a week at Iowa Grain observing operations, including compliance procedures. He also underwent additional training on compliance rules specific to the commodities market in connection with obtaining these licenses. He was well qualified to serve as supervisor of traders and brokers at RJFCO.

5. Chuck Kowalski was RJFCO's chief market analyst during all relevant time periods. His responsibility was to study the various commodities markets and develop firm recommended trades or trading strategies, which were then proposed to clients through the broker/traders. All such recommendations were then considered for approval by Raymond Fitzgerald subject to the client's ultimate approval. Kowalski had at his disposal sufficient market resources to aid in fundamental as well as technical analysis of the commodity market. In developing trade recommendations, Kowalski typically relied on the following sources: the Future Source Technical (a trading software program for technical analysis), the Wall Street Journal, Barons, Investor's Business Daily, the Hightower Report, Smith, Barney, 20 different Internet sites for 20 different market (with some overlap). He also consulted, in some instances, with another analyst available to the firm, Jim Dahir.

6. The other brokers and traders at RJFCO had access to much of the same information though they relied upon Mr. Kowalski's trade recommendations in many instances,

particularly in the trades that lie at the center of this dispute. Traders were not, however, required to accept and only recommend Kowalski's developed firm trades. Brokers were permitted to, and often did, recommend trades and strategies other than those chosen by Kowalski, with the approval of Raymond Fitzgerald. In addition, some clients directed their own trades. All trades were pre-approved by clients before they were placed.

7. RJFCO operated in perhaps a unique manner in that it employed one team of sales brokers primarily responsible for generating customers via telephone solicitations. As a separate function, a second team of broker/traders handled all of the actual trades and account monitoring functions. Both sets of brokers were required to be Series 3 licensed. Despite the Commission's suggestions during its opening statements of the trial, no evidence was adduced at trial to establish that this bifurcated system of account management was for a nefarious or improper purpose. Mr. Fitzgerald and Mr. Kowalski testified persuasively that the purpose was to have less experienced brokers solicit clients while slightly more or significantly more experienced brokers interfaced with clients on issues related to trading and account monitoring and to allow traders to focus on trades, not on customer solicitation or "cold calling." Defendants established that the bifurcated system worked as designed with newer brokers having no substantial involvement in account trading and management.

8. Because all RJFCO brokers and supervisors were required to be licensed as Series 3 commodity brokers, all were required to pass the NFA Series 3 Exam before serving as a sales or trading broker. In addition, all RJFCO supervisors were required to and did take and pass the National Association of Securities Dealers/NFA Series 30 Branch Office Manager Exam. Both the Series 3 and Series 30 examinations dealt extensively with NFA rules and regulations. The Series 30 materials dealt extensively with compliance issues. RJFCO supplied to incoming employees

the Series 3 Exam preparation manual and trained brokers in preparation for the exam. This training, conducted for most of the relevant period by Fred Fykes, was extensive and thorough, covering a wide range of topics, such as futures trading theory, basic functions terminology, futures margins, option premium price limits, futures settlements, types of orders, customer accounts, price analysis, basic calculations, hedging commodity futures, speculating in financial monetary futures, speculating in commodity futures, options hedging, CFTC and NFA regulations. Traders were also required to watch a four hour compliance video and complete a workbook based on the videotape as part of a continued professional education requirement.

9. Every new employee of RJFCO received a copy of RJFCO's compliance manual along with instructions to read and acknowledge that they read it, and all agreed to abide by it. Adequate and reasonable procedures were in place to ensure that brokers followed the mandates of these compliance standards.

10. The company diligently trained its employees to follow the standards of the industry as established in NFA regulations. For instance, the company had a policy, which it consistently stressed to its employees, against guaranteeing profits to prospective customers and clients. No evidence was offered to the contrary.

11. RJFCO's assertions to consumers of its resources, experience, credentials and services offered and rendered, though somewhat exaggerated by sales puffing, were largely substantiated at trial and were in no way false, misleading or deceptive or intended to be so.

12. Prior to the time period alleged in this action, RJFCO had a very competitive and very clean compliance record. Evidence established very few formal complaints lodged against RJFCO with the NFA and only slightly more informal complaints and reparation demands by clients.

13. The Commodity and Futures Trading Commission ("CFTC"), the National Futures Association ("NFA") and Iowa Grain conducted periodic audits with the firm, finding no significant irregularities in operations or compliance in the time periods that predate the window period challenged in this enforcement action. Such audits occurred on August 12, 1996, nine months after inception of the alleged scheme to defraud, again at the end of 1997 and at the end of April 1998. Iowa Grain's principal compliance officer during the relevant time period was Anne Farris. Ms. Farris pre-approved all promotional material now challenged by the CFTC in this action except the video version of the challenged CNBC promotional advertisement that aired approximately two weeks in March 1998.

14. It was the firm's policy to disclose consistently to customers the high risks inherent in the commodity trading market. The predominant evidence is that the firm's policy of requiring customers to read and endorse risk disclosure statements prior to opening accounts, was strictly enforced. In fact, Mr. Fitzgerald personally reviewed each new client packet for compliance. Further, risk disclosure booklets ("booklet 2") were sent to every client. Clients were required to certify by signature that they had read the disclosures and were aware of the risks before they were allowed to open accounts with the firm. The evidence established either conclusively or by a preponderance of the evidence that as to all the individual customers put forth by the CFTC, all received and had an opportunity to review booklet 2—the risk disclosure booklet.

15. As it pertains to customer Robert Bingham, the evidence is less clear when and how he actually received his complete disclosure booklet. During a brief period, the company tried a different approach of allowing traders to fax risk disclosures, but this practice was quickly suspended. Before then and subsequently, a single group of individuals, including Kathy Dempsey and Erica Bogardus, was responsible for mailing new account packets, with the risk

disclosure booklet, to clients prior to their opening accounts. The CFTC offered evidence that Bingham was faxed a partial form and never received by mail the original, entire package before trading commenced.

16. The evidence established conclusively, however, that Bingham signed an acknowledgment that he received the booklet on March 5, 1998. His trading commenced on March 6, 1998. In opening his account and allowing trading, RJFCO, RJFCO's principal and Iowa Grain reasonably relied on Mr. Bingham's representation. Further, Bingham acknowledged at trial that risk of loss was disclosed to him and that he was never guaranteed profit in connection with his trades and was never told to disregard the risk disclosures.

17. Prior to the opening of any account, Raymond Fitzgerald reviewed and approved the account opening documents. In addition, all completed account opening forms were reviewed by Iowa Grain Compliance officers. No account could be opened or was opened without the prior approval of Iowa Grain.

18. It was not the firm's practice to make material misrepresentations to clients, in connection with the offer to enter into, the entry into, or the maintenance of any commodities transaction. The firm affirmatively discouraged employees from doing so and had ample procedures in place to enforce compliance.

19. While there may have been an aberrant occasion where an overzealous trader may have made marginally, misleading representations, these occasions were rare and certainly not proven to have been part of any knowing disregard for policy by the firm or its officers.

20. Consistent with the firm's advertisement that it was a full service introducing brokerage house, it had a research and analysis component, offered a varied range of investment services and offered individual trade

recommendations. As such, this representation was not false.

21. It was not proven that the firm's win/loss record was any worse than that experienced by other firms in the industry. In fact, the only evidence adduced at trial established that the firm's success rate was consistent with or higher than that achieved industry-wide. Further, there was no evidence that the firm claimed that it had a superior win/loss record.

22. In fact, trading in commodities markets is inherently risky. One essentially bets on price fluctuations in markets which are driven by inherently unpredictable factors such as weather, politics, consumer consumption and future price movement predictions based on historical performance. The majority of people who trade in futures and options in commodities markets lose money. As a result, an individual's risk tolerance has to a certain extent already been demonstrated by their very choosing to enter into this very risky market. All the clients who traded with RJFCO expressly acknowledged by their signatures that they understood the level of risk involved. Every single page of the account opening package contained further disclosures and warnings about the high risk inherent in commodities trading. The CFTC offered evidence that RJFCO did not generate customer profits. Even if true, no such obligation existed to assess risk tolerance of each customer before making trade recommendations where, here, no discretionary account is in dispute and, thus, each customer approved each and every trade before such trades were placed. Additionally, the customers were expressly advised that only risk capital should be invested in this market. Further, RJFCO did not engage in "cold calling" in the traditional sense. Its customer base consisted largely of persons who had themselves first inquired into commodity trading.

23. As the controlling person in the firm, Raymond Fitzgerald instituted and maintained a reasonably efficient

system of internal supervision and control. Further, the system was enforced with reasonable diligence. There was no evidence that Raymond Fitzgerald was aware of any violations and recklessly or intentionally failed to remedy any violations.

24. The firm and its officers were diligent in monitoring the brokers, both on the sales and trading side of the business. During the relevant period, Greg Burnett, Chuck Kowalski and Raymond Fitzgerald openly supervised the brokers' telephone calls, but also, without prior notice to brokers as to particular calls, listened to their solicitations of customers on a phone monitoring device.

CFTC'S WITNESS TESTIMONY

25. The CFTC's core case consisted of relatively little direct evidence through customers. RJFCO had over 1200 customers during the relevant period. Yet, evidence of only seven alleged incidents of customer fraud was offered from which to establish the pattern or practice of fraud. The testimony was not compelling in quantity or quality.

26. At trial, the Court heard the testimony of Robert Bingham, a RJFCO customer during March 1998. The Court finds Mr. Bingham's testimony not fully credible. Mr. Bingham testified that he did not know anything about investing in commodities or the risks involved and that he told his trader, Al Coringrato, that he wanted a safe investment as he was risk averse. On the other hand, Mr. Bingham testified that he was a gambler, who frequented casinos 20-25 times per year, with a tax write-off in gambling losses of at least $27,000 in the year in which he traded with RJFCO. He also testified that he had maintained several stock and mutual fund investments for at least six years with another brokerage firm. Additionally, while Mr. Bingham testified that he knows he did not receive the body of "booklet 2" because he was in the habit of saving everything he received related to his investments, he testified

that he threw away the monthly statements from Iowa Grain which showed a loss of $25,000.

27. The Court similarly does not find the testimony of Diane Banks-Pazzanese to be fully credible. She attempted to represent that the funds she used in her investment with RJFCO were from her last reserve of savings. Upon further examination, Ms. Banks-Pazzanese was revealed to be a successful businesswoman who owned the building in which her hair salon was located, owned her own home, and reported to RJFCO she had a net worth of approximately a quarter of a million dollars. She acknowledged that she understood there was a risk of loss and she certified by signature that she received booklet 2. The Court accepts that sales practices, especially as it pertains to Ms. Banks-Pazzanese, may have involved pressure by the trader, Fred Fykes, that may have gone beyond industry standards, but this was not a claim asserted by the CFTC. Nor was it proven that RJFCO or the named Defendants were aware of this sales solicitation. Further, Ms. Banks-Pazzanese initiated contact with RJFCO in the first instance.

28. The Court does not find the testimony of Robert Friedman to be credible. Mr. Friedman testified that his trader did not explain what a synthetic futures trade was. However, in notes which he acknowledged were in his own handwriting, he wrote precisely what trades were recommended to him and noted also that synthetic futures would expose him to "unlimited downsize risk". At trial, without prompting, he corrected this statement in his notes to "unlimited downside risk" and explained that he understood this to mean he could lose more than his initial investment. His assertion that he was confused and did not appreciate the risk of loss was further damaged by his testimony, on cross-examination, that he had previously lost $150,000 in a previous stock options transaction in which, but for negotiations with the broker, he would have lost substantially more than his investment.

29. Linda Ralston admitted that she received booklet 2 with the new account packet. Despite clear warning in the literature against it, she opened her account with borrowed funds. She approved all the transactions as well as the commissions earned by RJFCO.

30. Paul Patterson represented that he did not understand the risks involved in commodity futures and options trading. Yet, he traded stocks online for several years before opening his account with RJFCO. Additionally, he testified that he did not receive booklet 2, but the only evidence of this during his testimony was a computer transmittal document which did not contain the full copy of booklet 2. Mr. Patterson could not establish whether the printed document represented the complete file transmitted by RJFCO to him. In response to a demand from RJFCO counsel at trial, Mr. Patterson later submitted to the Court a hard copy of the portion of the RJFCO original application booklet after he testified that he had only ever received the computer generated materials. Finally, he, like the other customers, acknowledged in writing that he understood the risks of the trade he was entering.

31. Daniel Danaher, also a customer, maintained that he contacted RJFCO because he wanted to learn about commodities training. When he did receive the instructional packet, with charts, from RJFCO, however, he admits he spent only fifteen to twenty minutes looking at it and did not study the materials. Also, Danaher testified that he never authorized any of the trades executed on his account. On cross-examination, however, he admitted that there was actually only a single trade, and he did, indeed, authorize it.

32. The Court did not find the testimony of Scott Kelley, another customer, to be fully credible. His testimony that he received the business card, that evidence showed usually accompanied the RJFCO new account packet, but did not receive the packet with booklet 2, is suspect in itself. More unbelievable is his statement that he entered into this

transaction without full disclosure in light of his other testimony that he waited for over a year, studying commodity futures and monitoring the corn market before entering his trades at RJFCO. He testified that he only entered the trades here after he confirmed the price movement that Mr. Kowalski, for RJFCO, was projecting. Further, his testimony that he did not understand his trades is undermined by the substantial experience he had in the commodities market in his work as vice-president of marketing at Kelley Foods, a multi-million dollar wholesale food distributor and meat processor. As part of his duties, he monitored commodity futures prices from the Chicago Board of Trade and followed futures prices on a daily basis when making large purchases of commodities for Kelley Foods.

33. The Court also finds the testimony of Robert Eubanks, a trader offered by the CFTC, was not fully credible. He testified at length on direct that RJFCO officers discouraged him from teaching customers about the trades in their accounts and about the market in general. On cross-examination, however, he admitted that he had actually received several letters from customers thanking and complimenting him for spending substantial amounts of time teaching them and discussing their trades. In a sworn statement filed in opposition to an unrelated reparation action, Eubanks stated under oath that "I can produce numerous letters from clients stating that I'm one of the most patient, informed brokers they have ever had and that I was always willing to go the extra mile to explain things." Eubanks also testified that he never made misrepresentations to customers and never failed to disclose risk or to educate customers fully. Further, after testifying that the Series 3 Exam training he attended stressed the importance of disclosing risk to customers, as did Leiza Fitzgerald's training sessions, Eubanks stated that when he became a trader he did not know he was supposed to, as a matter of law, disclose all risk to clients. Eubanks' demeanor at trial and his inconsistent testimony on these very important

matters rendered his entire testimony of limited assistance to the Court.

34. The Court similarly finds the testimony of Dale Skinner, another trader, not fully credible. Skinner testified that he was discouraged from talking to clients about their accounts and the market. Conversely, he testified that each of the four traders rotated late evening shifts during which they took calls from customers calling about their accounts and other questions. He also testified that he called customers and talked to them about their positions and the market. Significantly, he consulted with counsel for four continuous hours prior to testifying at trial.

35. Victor Shelton testified that he told every customer that they had to read booklet 2 and directed them to sign their acknowledgment that they received and read it. He also testified that he never saw a profitable trade. In support of its summary judgment motion, the Government promised to offer the testimony of Mr. Shelton to support the contention that the Defendants had made admissions that RJFCO's trade recommendations were based solely upon a desire to generate commission without regard to the customers' best interest. Mr. Shelton's testimony was not consistent with the promises made and was of limited assistance to the Court. In any event, his tenure with the company was only 16 weeks long.

DEFENDANTS' WITNESS TESTIMONY

36. Conversely, the testimony of Greg Burnett was credible. The CFTC attempted to impeach Mr. Burnett's credibility generally by questioning him regarding a previous substance abuse problem. Mr. Burnett's testimony, in response, was straightforward and frank, and he testified honestly that he had a substance abuse problem from 1997 through the first quarter of 1998. In February 1998, he took a leave of absence from RJFCO and voluntarily, with the aid of Mr. Fitzgerald, entered a rehabilitation facility and returned to RJFCO in March 1998. The Court does not find

that his performance at RJFCO was significantly impacted by his substance abuse. The CFTC also introduced evidence that Burnett had been named as a Defendant in an arbitration while at Olde Financial. Upon further questioning, it was revealed that Burnett had been released from the suit and that he had made full disclosure of the legal actions against him to the CFTC in his licensing applications. Further, the Plaintiff in the Olde Financial lawsuit apparently had subsequently been convicted on federal charges and incarcerated. Finally, the CFTC attempted to establish that Mr. Burnett had a number of financial problems—including an IRS debt, child support obligations and alimony obligations—which the CFTC argued would establish motive for him to commit fraud at RJFCO. The CFTC's questions and contentions had no basis in fact. Burnett testified that the IRS debt of $17,000, occasioned by his late payment of quarterly withholdings, had been fully paid by 1996 well before he came to RJFCO, and that he had no children and no alimony obligations.

37. Similarly, Chuck Kowalski's testimony was credible. His demeanor throughout direct and cross remained straightforward, honest and frank. His testimony regarding the firm's operation was extremely informed, precise and consistent with the evidence.

38. Leiza Fitzgerald testified credibly regarding her numerous leaves of absence from the firm during the relevant period due to complications with her pregnancy, illness and an accident. During the limited time when she was active at the firm, she was primarily responsible for conducting the sales training for the new brokers. In so doing, she taught them to utilize various solicitation devices that she had been taught. For instance, she taught brokers to employ the "Give, Get, Sell" technique whereby they were taught to "give" the customer a piece of relevant information about the market to arouse their interest, "get" information from the prospective client about themselves and their interest in trading, and then "sell" the customer on opening

an account. Another closing technique was "Agree, Disarm, Comeback," pursuant to which sales brokers were trained to diffuse customer objections to sales pitches. The evidence at trial revealed these to be standard sales technique in the industry and they were utilized by RJFCO consistent with the industry and not as a tool to mislead prospective clients. Mrs. Fitzgerald testified credibly that a cornerstone of her training was to admonish sales brokers to disclose the substantial risk associated with options trading. In connection with her various sales trainings, Leiza Fitzgerald did not intend to cheat, defraud or mislead clients or prospective clients.

39. Raymond Fitzgerald testified credibly at trial that he reviewed all the account opening statements and relied on the acknowledgments of the customers that they had received, read and understood all the risk disclosures which accompanied the statements. Further, with regards to promotional materials, he submitted them to Iowa Grain for compliance review and also relied on the review of the materials conducted by Anne Farris, Iowa Grain's compliance officer. Mr. Fitzgerald's testimony that he attempted to create an environment where compliance was paramount and risk disclosure was considered critical was credible.

40. Raymond Fitzgerald sent two brokers, Scott Campbell and Tom West, to give sales seminars on commodities trading. Neither Mr. Fitzgerald, nor anyone else with supervisory authority, attended the sales seminars. Prior to sending the brokers to make the presentations, however, Mr. Fitzgerald reviewed all the materials for the seminars and had the brokers do practice runs of their planned presentations.

41. Raymond Fitzgerald participated in developing the synthetic futures trade at the center of this enforcement action. He testified that he approved this trade recommendation, but instructed brokers to explain it to

clients and obtain their prior approval before entering the trades. Mr. Fitzgerald conceded that he knew the trade was risky, but that it was a calculated risk with the potential for high returns. One of the brokers testified that he overheard Mr. Fitzgerald making a bet against the price of corn rising. Mr. Fitzgerald admitted at trial that he did make a bet with Mr. Kowalski, but that the bet was on how high the price of corn would rise. Both prices wagered by Fitzgerald and Kowalski were high enough to reap the type of return on client investments that the firm anticipated when they implemented the synthetic futures strategy. The Court finds that Raymond Fitzgerald was not motivated solely by commissions in recommending the synthetic futures trade, but genuinely anticipated the strategy would manifest a high return for client accounts. Mr. Fitzgerald testified credibly that it was not his intent nor his company's to cheat, defraud or deceive his or RJFCO's customers.

THE FACTORS PRECIPITATING SUIT

42. In the spring of 1998, however, a confluence of factors placed RJFCO in the regulatory spotlight. The firm recommended to its clients this high risk trade strategy known as a synthetic future.

43. A long synthetic futures position seeks to exploit anticipated price movements in the market vis-a-vis the particular commodity being traded by using both puts and calls in a combined trade strategy. On one hand, the trade consists of a long call option—that is the future right to buy an option at a predetermined price. The buyer essentially bets that the predetermined price will be lower than the actual market price before the contract expires. The trader will, in that instance, exercise the option and reap the benefits of the "bargain" price. Simultaneously, the trader sells to another the future right in that other person to force a sale to the trader of a contract at a predetermined price, which the seller bets will be lower than the market at the time the contract matures, because the seller believes prices

will rise. Obviously, if the seller's predictions are realized, the buyer will not exercise the option and the contract will expire worthless. In that event, the seller will keep the consideration paid as the profit on the transaction. Thus the trader has achieved a win/win on both sides of this transaction.

44. If prices fall, however, the seller loses on both sides as well. On the long call, the seller loses the initial investment plus commissions because he will not exercise the option; but that is the limit of potential loss. On the short put the consequences can be more dire. On that side of the transaction, if prices fall, the trader is obligated to buy the contract from the initial buyer and at a price higher than the original consideration received. The difference in the consideration received in the initial sale and the price of the commodities contract in the market, whatever that difference may be, is called margin. That margin must be paid by the initial trader (the RJFCO customer) on demand to cover the loss—that is to permit the clearinghouse to purchase the contract and consummate the previously agreed upon contract for sale. Therein lies the unlimited exposure of risk in selling put options. It is this exposure that lies at the heart of this dispute, though, ironically, no customer suffered loss beyond his or her initial investment because RJFCO sold these contracts at a loss of initial investment before the price fluctuation subjected RJFCO customers to meet margin calls.

45. The trading strategy was bullish on corn[3] and required for its success a significant and dramatic rise in the price of corn futures in the contract period. Kowalski developed this strategy based on research suggesting that corn prices would rise due to certain predicted market forces, including the El Nino weather phenomenon, resulting drought conditions, decreased acreage of corn being planted, and heightened demand for corn. The decision, though

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[3] Bullish refers to an expectation of an increase in price or volatility.

risky, was based on deliberate research and logical assumptions and the strategy was developed primarily to yield profit for RJFCO clients, not simply to generate commissions.

46. Typically, the firm never previously recommended selling options, so this synthetic futures strategy also constituted a departure from the firm's investment philosophy. Before the strategy was implemented, the firm's clients were contacted and informed of the precise nature of the trade, and RJFCO disclosed that the move to selling puts exposed them to virtually unlimited risks of loss. Some customers declined and those customers were not placed in the synthetic futures position.

47. In making the predictions about the price of corn and developing the synthetic futures strategy, which was supposed to be the vehicle by which the price increase was to be exploited, Kowalski studied numerous reports from various sources including: the Hightower Report, Smith Barney, Prudential Securities, Stewart Peterson, Freese-Notis. He also researched the weather through the following sources: Freese-Notis, Weather.com, Iowa Grain meteorology reports, and Crop Cast.

48. Kowalski predicted that weather problems would start to be factored into the corn prices in December of 1998, when the new crops are harvested.

49. Kowalski deliberately chose a synthetic futures strategy rather than a straight futures position even though the straight futures contract could achieve the same effective position in the market but with half the number of trades. Kowalski reasoned that the volatility of the market during that period increased the likelihood that customers in a futures position, which bore a more direct relationship to price movement in the underlying commodity, would

quickly reach their stop loss position[4] and be knocked out of the position or be exposed to losses exceeding their investments.

50. Because the synthetic futures strategy required twice as many contracts to be placed in a customer's account, it generated twice the commission, a fact on which the CFTC relied heavily in establishing motive to defraud. Specifically, the CFTC's expert, Peter Locke opined that the two-pronged structure of the synthetic future, coupled with the commissions, doubled by the simultaneous combination of long call and short put options, rendered the scheme incapable of delivering a profit for customers regardless of whether corn prices increased or not. Based on this opinion, CFTC alleges that RJFCO implemented the synthetic futures strategy only to generate commissions. The Court disagrees. In connection with the synthetic future strategy, RJFCO recommended the selling of puts in part to generate funds for the client accounts to provide some margin in the likely event of market volatility. Further, the funds generated on the sale of the options generated enough money to pay for or substantially offset the RJFCO commissions on one side of the transaction. Finally, the Court finds that the strategy was implemented to generate profits for customers, and it could have done so had the price of corn risen as expected.

51. As part of its marketing strategy for corn trades, for two weeks in the beginning of March 1998, the firm aired a promotional advertisement on CNBC, in which it represented that the El Nino weather phenomenon could produce huge profits in the grain markets. The prediction of El Nino's potential impact of grain prices was based on extensive study by RJFCO's researcher and analyst, Kowalski, and partially informed by various meteorological reports and sources, as well as reports from other

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[4] A stop-loss order is a standing order designed to close out a losing position and thus limit potential loss when the price of the commodity reaches a level specified in the order.

commodities analysts. The commercial was not deceptive or misleading. When the advertisement firm submitted the advertisement to Mr. Fitzgerald, he edited it and included additional risk disclosures. RJFCO sought and obtained pre-approval of the text of the advertisement by Iowa Grain's Compliance Director. After the advertisement had aired a few times during a brief period, Mr. Fitzgerald pulled the ad from the air. Shortly thereafter, NFA compliance officer, David Crooms, expressed some concerns to Raymond Fitzgerald about the statements in the commercial. Whereupon, Mr. Fitzgerald assured him that he did not plan to air it again. Based on these facts, even if the commercial could be interpreted as misleading *post hoc*, the Court finds that there was no intent to mislead or deceive customers through the airing of this advertisement.

52. Contrary to the firm's predictions to customers and on the air, corn prices plummeted in the crucial time frame. To limit the inevitable losses when the price approached the pre-designated support level[5], the firm contacted the clients to inform them of the declining position. RJFCO recommended closing the positions as the risk of closing with a negative balance was getting too high. All customers accepted this recommendation and their positions were sold. As a result, none of the customers sustained losses above their investment associated with the synthetic futures recommendation. Virtually all customers placed in bullish positions in corn, including those in synthetic futures, lost all or substantially all of their investments.

53. Simultaneously, or as a result, several brokers and traders defected from RJFCO and sought to violate their non-compete agreements and solicit the firm's clients. Those losing customers and several traders lodged complaints

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[5] The support is that price level where new buying is likely to stem any future decline. Kowalski determined this price point by consideration of past market movements. This type of technical analysis is widely accepted as one reasonable predictor of future market movement.

against RJFCO, prompting the investigation that led to the instant enforcement action.

54. Given that the firm's clientele was comprised primarily of individuals who were relatively inexperienced in commodities trading of any type, this transaction was too complicated and risky and should never have been recommended. Merely recommending a misguided trading strategy is not *per se* actionable, however. As set forth below the Undersigned finds that the CFTC failed to prove that RJFCO or individual defendants intended to cheat or defraud customers associated with this trading recommendation.

CONCLUSIONS OF LAW

This Court has jurisdiction over the subject matter of this action and the parties which is based on federal question. *See* 28 U.S.C. § 1331.

In this lawsuit the CFTC has alleged that the Defendants or some individual Defendant have violated the Commodity Exchange Act ("CEA") and Commission Regulations by (1) committing fraud by misrepresentation or omission of material facts in connection with the solicitation, maintenance, or execution of commodity futures transactions, (2) operating an introducing brokerage firm to cheat, defraud, deceive, or to attempt to cheat, defraud or deceive clients, (3) trading client accounts to generate commissions without regard for clients' interests, (4) failing to provide adequate risk disclosure statements prior to the opening or causing the opening of a commodities trading account, (5) failing to supervise diligently, all in violation of 7 U.S.C. § 6c(b), 17 C.F.R. § 33.10(a) and (c), 17 C.F.R. § 166.3, and 7 U.S.C. § 13c(b).

DISCUSSION

Counts One, Two, Seven, and Nine charge Raymond Fitzgerald, as principal; RJFCO, the firm; Leiza Fitzgerald and Greg Burnett with committing fraud by

misrepresentation or omission of material facts in connection with the solicitation of commodity futures transactions.

Count Three, Ten, and Fifteen charge Raymond Fitzgerald, as principal; RJFCO; Greg Burnett; and Chuck Kowalski with operating an introducing brokerage to cheat, defraud, deceive, or attempt to cheat, defraud or deceive clients.

Counts Four and Eleven charge Raymond Fitzgerald, RJFCO, and Greg Burnett with committing fraud by trading client accounts to generate commissions without regard for clients' interests.

Count Five charges Raymond Fitzgerald and RJFCO with failing to provide adequate risk disclosure statements prior to opening customer accounts.

Counts Six, Eight and Twelve charge Raymond Fitzgerald, Leiza Fitzgerald and Greg Burnett with failing to supervise diligently the sales practices and solicitations of RJFCO brokers.

Scienter

An essential element of any charge of fraud under the Commodity Exchange Act is that the allegedly fraudulent conduct be committed with scienter—or intent. Thus, scienter is a required element under the anti-fraud provision of the CEA. *See Wasnick v. Refco*, 911 F.2d 345, 348 (9th Cir. 1990). The Commission must show that the defendant intentionally violated the Act or acted with careless disregard of whether his actions violated the Act. *See CFTC v. Noble*, 67 F.3d 766, 774 (9th Cir. 1995). Allegations of negligence, mistake or inadvertence do not satisfy scienter under the Act. *See Damato v. Hermanson*, 153 F.3d 464, 476 (7th Cir. 1998). In the present case, proof of scienter is a required element of Counts One, Two, Three, Four, Seven, Nine, Ten, Eleven and Fifteen.

Specifically, Counts One, Two, Seven, and Nine charge Defendants with committing fraud by misrepresentation or

omission of material facts in connection with the solicitation of commodity futures transactions in violation of Section 4b(a)(i), (iii) and Section 4c(b) of the CEA and Commission Regulation 33.10, codified as 17 C.F.R. § 33.10(a) and (c).

Under those regulations it is unlawful for any person directly or indirectly to cheat, defraud or deceive or attempt to cheat, defraud or deceive any other person by any means in connection with an offer to enter into, the entry into, the confirmation of, the execution of, or the maintenance of, any commodity option transaction.

The CFTC alleges that the Defendants committed fraud by 1) using a television commercial which misrepresented the impact of the El Nino weather phenomenon on commodity price movement; 2) instructing brokers to mislead customers in their phone solicitations, especially as it relates to the firm's trading record, likelihood of profits and the nature of the risk involved; 3) using deceptive profit illustrations in promotional seminars.

Fraudulent Solicitations

CFTC alleges that RJFCO and Raymond Fitzgerald are liable for fraud in connection with the airing of a commercial which linked changes in commodity prices to the El Nino weather phenomenon. With regard to scienter, prior to airing the commercial Mr. Fitzgerald edited it to include additional disclaimers and disclosures. He also shortened the advertisement. Further, he submitted the advertisement to Iowa Grain's compliance officer, and the script was approved by Anne Farris. Upon being informed that the NFA had concerns about the commercial's content, however, Mr. Fitzgerald told the NFA that he would not air the advertisement again. As such, the Court finds no intent to defraud as it relates to the airing of the El Nino commercial. In any event, the Court finds that the commercial was not misleading or deceptive.

As part of its fraud allegation, CFTC also alleges that Defendants instructed brokers to make misrepresentation and

material omissions in their solicitations with customers. The evidence did not support this allegation. All the brokers who testified, both for CFTC and for the Defendants, stated that they were repeatedly instructed to tell the truth and not to guarantee profits. Further, each broker testified that he never made any misrepresentations in his solicitations to customers. As such, the Court does not find that the RJFCO principals instructed brokers and traders to make misrepresentations or intended to otherwise mislead or deceive clients and does not find that any broker ever made actionable misrepresentations to customers.

Next, the CFTC's claim that brokers committed fraud by failing to disclose the firm's trading record is without merit. In *Thomas v. Smith Barney*, 709 F.2d 1413 (11th Cir. 1983), the Court held that a broker owes a duty of full and fair disclosure to an investor and in order to sustain a cause of action, the investor must establish (1) the scienter of the defendant, (2) the materiality of any misrepresentation or omissions by the defendant, (3) the extent of actual reliance by the plaintiff on the defendant's statements and (4) the justifiability of the reliance.

In the present case, the investors and the respective brokers to whom they spoke clearly maintained a fiduciary relationship which involved a duty to disclose. In keeping with this duty, the firm's practice was to send out risk disclosure booklets and incorporate the practice of disclosing risk in all their solicitations to clients. Further, a large portion of the firm's training sessions was devoted to ensuring that its brokers and traders fully understood and complied with the firm's policy of full disclosure. With this, the Court finds that the Defendants fully discharged their duty of disclosure and, under these facts, were not under any additional duty to disclose the firm's trading record.

In any event, CFTC failed to prove that the trading record of RJFCO was substantially different from that of other similarly situated firms, or that brokers ever represented to

clients that the firm had a superior trading record, giving rise to any duty to disclose. Under these circumstances, the Court does not find that RJFCO was under a duty to disclose the firm's track record or that there was any intent to deceive or defraud in association with omissions relating to the matter.

Lastly, as it pertains to intent to defraud in reference to the profit illustrations the firm utilized in its promotional seminars, the Court considers that RJFCO's practice of having the scripts and illustrations approved by Iowa Grain's compliance officer. In addition, the Court does not find that there was anything patently or latently misleading or deceitful about the profit illustrations. Defendants established that such illustrations are used even in NFA manuals submitted to brokers for their consideration. While the promotional seminars did suggest that an investor could see a very high return on investments, there was also ample disclosure regarding the high risks involved. The Court agrees that more diligent supervision of actual presenters at the seminars could have been employed. Mr. Fitzgerald testified that practice runs of the presentations were conducted prior to allowing presenters to address potential clients, but that neither he nor anyone with supervisory authority attended the presentations in a supervisory capacity. In any event, such failure, even if negligent, is insufficient to establish fraudulent intent. In fact, the only customer who testified that she was solicited via a seminar acknowledged that risk of loss was described to her.

Finally, the CFTC claims that the mere attempt to deceive, defraud or cheat is actionable, even absent any proof of actual fraudulent conduct. The CFTC argues, therefore, that the Defendants' alleged acts of instructing traders and brokers to make misrepresentations to customers violated the CEA's prohibitions against attempted fraud, even though there is no evidence that any misrepresentations were actually made.

It is a violation of the CEA to attempt to defraud or cheat any person in connection with an offer to enter into, confirmation of, execution of, or the maintenance of any commodity futures transaction. 17 C.F.R. § 33.10. As in other aspects of the law, a *prima facie* showing of attempt to cheat or defraud requires evidence of some overt act or substantial step in the commission or preparation to commit the violation. That overt act must be sufficient to demonstrate the intent of the Defendant to cheat or defraud a person in connection with a commodity option transaction.

By way of analogy, it is well-established in the criminal law context that a conviction for the crime of attempt requires, first, that the defendant must have been acting with "the kind of culpability otherwise required for the commission of the crime which he is charged with attempting" and second, that "the defendant must have engaged in conduct which constitutes a substantial step toward the commission of the crime." *United States v. Forbrich,* 758 F.2d 555, 556 (11th Cir. 1985). The "substantial step" must be conduct that is strongly corroborative of the firmness of the defendant's criminal intent. *Id.* at 556.

Thus, even an attempt to deceive, defraud or cheat customers in connection with a commodities transaction requires at least the same showing of scienter. The Court does not find scienter and, therefore, does not find any liability for attempted fraud under the CEA.

The Synthetic Futures Trade Recommendation

The CFTC also alleges that the firm and individual Defendants traded in the clients' accounts for the primary purpose of generating commissions without regard to clients' interests. Specifically, the CFTC alleges that the synthetic future trade was recommended with no reasonable basis in fact and was only recommended to generate commissions—which were doubled because of the multi-faceted nature of the trade strategy.

Upon consideration, the Court finds that RJFCO and the individual Defendants recommended this trade to clients only after extensive study of numerous reports from various sources. These reports substantially bolstered their belief that the price of corn was due to rise dramatically. Kowalski also analyzed numerous meteorology reports which supported his prediction that weather problems associated with the El Nino weather pattern would start to be factored into the corn prices in December of 1998. It was based on this analysis and these forecasts that the Defendants sought to take full advantage of the marker movement by implementing this risky trade strategy—a strategy which essentially seeks to benefit twice from the same commodity price movement. As such, the Court finds that though, in hindsight, the trade strategy was too risky for the firm's clientele, it was recommended based on reasonable analysis of market events and not for the primary purpose of generating commissions. Further, Raymond Fitzgerald instructed the traders to explain fully to the clients the trade strategy, and all clients who were put into the trade gave their consent beforehand. The Court does not find any intent by any of the Defendants to defraud or cheat customers in association with the recommendation of the synthetic futures trade strategy.

Based on the foregoing, the Court finds that there was no intent on the part of the Defendants to cheat, defraud or deceive or attempt to cheat, defraud or deceive any person in connection with the offer to enter into, the entry into, the confirmation of, the execution of, or the maintenance of, any commodity option transaction. The Court, therefore, finds for the Defendants as it relates to Counts One, Two, Three, Four, Seven, Nine, Ten, Eleven and Fifteen.

Controlling Person Liability

A central feature of the CFTC's claims against Raymond Fitzgerald involves his role as the controlling person in the

firm, having direct control over the persons accused of the underlying violations.

Controlling person liability is created pursuant to 7 U.S.C. § 13c(b) which provides:

> Any person who, directly or indirectly, controls any person who has violated any provision in this chapter may be held liable for such violations in any action brought by the Commission to the same extent as such controlled person. In such action, the Commission has the burden of proving that the controlling person did not act in good faith or knowingly induced, directly or indirectly, the act or acts constituting the violation.

7 U.S.C. § 13c(b).

"A controlling person acts in bad faith if he did not maintain a reasonably adequate system of internal supervision and control over the employee or did not enforce with any reasonable diligence such system." *Monieson v. CFTC*, 996 F.2d 852, 860 (7th Cir. 1993). The controlling person must also act recklessly; negligence alone is insufficient. *Id.*

The weight of the evidence in the present case supports a finding that Raymond Fitzgerald did maintain a reasonably adequate system of supervision and it was enforced with reasonable diligence. Fitzgerald instituted a system of supervision which involved several different components. During the relevant period, the brokers were directly supervised by Greg Burnett, either by direct, proximal observation or by a phone monitoring device. Fitzgerald also walked the floor and monitored phone conversations. In addition, Raymond Fitzgerald directly reviewed every new account packet for compliance before accounts were opened, reviewed and approved all trades before they were placed, and he hired competent and experienced supervisors. Greg Burnett, for instance, had significant prior experienced supervising a branch office and eventually managing seven branch offices. All promotional materials were audited by

Anne Farris of Iowa Grain. RJFCO, at Mr. Fitzgerald's insistence, also required all brokers and traders to read and keep its compliance manual. As a result of all the safeguards, RJFCO's internal and external audits were satisfactory.

In addition, the CFTC's claim as it pertains to this provision suffers from two critical deficiencies. First, the Commission failed to prove that Raymond Fitzgerald was aware of any CEA violations and, in bad faith, failed to act. Second, the CFTC did not prove any underlying violation of the CEA by RJFCO employees. As it pertains to the latter, this deficiency also undermines the CFTC's claims against all the individual Defendants for aiding and abetting. Without proof of an underlying violation, the Court cannot find any liability for aiding and abetting in this case. As such, and based on the foregoing, the Court finds for the Defendants as to the CFTC's charges against Raymond Fitzgerald, as the § 13c(b) controlling person, and all the individual Defendants for aiding and abetting pursuant to § 13c(a).

Failure to Supervise

The CFTC also alleges that RJFCO's officers failed to supervise employees and are therefore liable under 17 C.F.R. § 166.3, which provides:

> Each Commission registrant, except an associated person who has no supervisory duties, must diligently supervise the handling by its partners, officers, employees and agents . . . of all commodity interest accounts carried, operated, advised, or introduced by the registrant and all other activities of its partners, officers, employees and agents . . . relating to its business as a Commission registrant.

17 C.F.R. § 166.3.

The Court finds that Defendants put into place an adequate supervisory system and that system was diligently administered. For that reason and the reasons discussed

above, the Court finds for the Defendants as to Counts Six, Eight and Twelve.

Duty to Disclose Risk

The CFTC additionally alleges that Defendants failed to make § 33.7 risk disclosures. 17 C.F.R. § 33.7 provides, in relevant part:

> (a)(1) . . . no futures commission merchant, or in the case of an introduced account no introducing broker, may open or cause the opening of a commodity option account for an option customer, . . . unless the futures commission merchant or introducing broker first:
>
> (i) Furnishes the option customer with separate written disclosure statement as set forth in this section or another statement approved under § 1.55(c) of this chapter and set forth in appendix A to § 1.55 which the Commission finds satisfies this requirement, or includes either such statement in a booklet containing the customer account agreement and other disclosure statements required Commission rules; . . . and
>
> (ii) . . . receives from the option customer an acknowledgment signed and dated by the option customer that he received and understood the disclosure statement.

This allegation does not require a finding of scienter. The treatment of the risk disclosure requirement in the CEA is more akin to a strict liability standard, but certain presumptions exist in the law when a broker diligently seeks to ensure that customers have received disclosures and understand the risks associated with their investments.

In this regard, once a customer signs and acknowledges that he or she received full disclosure of risk and understands same, a presumption of compliance with § 33.7 arises in favor of the broker. That is, it is assumed that an adequate disclosure was made under the law. This presumption may be vitiated, however, by a showing that brokers made misrepresentations about risk to customers which undermine

the importance of the risk disclosures initially given. *See Clayton v. Commodity Futures Trading Commission*, 794 F.2d 573 (11th Cir. 1986).

In the present case, CFTC alleges that customers did not receive the full risk disclosure booklets and that brokers did not otherwise properly disclose the nature of the risk inherent in commodities trading. While the customers initially testified they did not understand the risk, each acknowledged the risk by his or her signature on the risk disclosure forms and, each acknowledged receipt of the additional risk disclosure on virtually every page of the account opening documents he or she completed. There was some question as to whether the customer Robert Bingham actually received every page of his disclosure booklet. Bingham did acknowledge on the application and account opening documents that he received, read and understood the risk disclosure booklet. Also, there was no evidence than any broker attempted to minimize the risk of loss to Mr. Bingham or any other customer. *See, e.g., CFTC v. Sidoti*, 178 F.3d 1132 (the effectiveness of the risk disclosure diluted by broker's description of the disclosures as mere formalities and encouragement to customers not to read them). Thus, the presumption of the validity of the signed acknowledgment stands as to Mr. Bingham.

Further, the Court finds the testimony of Kathy Dempsey to be credible and informative in this regard. Ms. Dempsey testified that the brokers were charged with soliciting new clients. Prior to the opening of any account or any trading, however, a single group of individuals, consisting of Ms. Dempsey and Erica Borgardus, were responsible for mailing new account packets with the entire risk disclosure booklet. These individuals operated from a room to which brokers and traders did not have free access. Ms. Dempsey and Mr. Fitzgerald testified credibly that the purpose of denying brokers access was to ensure conformity of process and compliance. In addition, Mr. Fitzgerald personally reviewed every new account to ensure that all the disclosure forms had

been sent to clients and the acknowledgments were signed. Finally, before a trade could be placed with Iowa Grain, the clearing house, Iowa Grain's own compliance officers also reviewed the new account forms for risk disclosure compliance.

Based on the foregoing, the Court finds that RJFCO and Defendants had a reasonable and efficient system in place to ensure consistent compliance with risk disclosure rules, and Defendants did provide risk disclosures as required under 17 C.F.R. § 33.7 to each customer prior to opening or causing to be opened any commodity option account. Accordingly, the Court finds for the Defendants as to Count Five.

CONCLUSION

Based on the foregoing, the Clerk of Court is directed to enter judgment in favor of the Defendants RJFCO, Raymond Fitzgerald, Leiza Fitzgerald, Greg Burnett and Chuck Kowalski as to all Counts of the complaint. With that, all pending motions are denied as moot.

DONE and **ORDERED** in Tampa, Florida on May 18, 2001.

s/ MARY S. SCRIVEN
UNITED STATES MAGISTRATE JUDGE

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA
TAMPA DIVISION

COMMODITY FUTURES TRADING COMMISSION, Plaintiff,	Case No. 8:99-Cv-1558-T-MSS
v.	
R.J. FITZGERALD & CO., INC., RAYMOND FITZGERALD, LEIZA FITZGERALD, GREG BURNETT, AL CORINGRATO, and CHUCK KOWALSKI,	March 8, 2001 (Cont)
Defendants. /	9:30 a.m.

(Volume XI)
TRANSCRIPT OF BENCH TRIAL
BEFORE HONORABLE MARY S. SCRIVEN
United States Magistrate Judge

APPEARANCES:

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* * *

[1516 * * *] THE COURT: All right. It's difficult to parse out portions of this case on a directed verdict following the complaint as it is drafted in counts. Because within the various counts are various allegations that go to prove or disprove different things.

And some of the issues raised here will require the Court to review the transcript and to take a bit more time reviewing the documentary evidence that has come in. But some of the things do not require any further consideration because the Court has undertaken [1517] substantial consideration of the issues during the course of the presentation of the evidence and consideration of the law.

And quite aside from the issue of whether Mr. Locke is to be credited in any regard regarding the EMT, it seems to the Court that in any event what is being touted in the commercial in regard to El Nino is not use of publicly known information for the purpose of selling commodities except that everyone knew that there existed an El Nino.

I think the evidence establishes clearly that no one knew for sure what its effects were going to be in the market, clearly not R.J. Fitzgerald and, apparently, clearly not others in the market unless the person who bought this calls that Mr. Bourne sold was also a R.J. Fitzgerald client which hasn't been established.

And I think that's different in some regards than oil prices go up in the winter because people use more oil in the winter because people do use more heating when it's cold, and it's more likely cold in the winter than not. I question whether that is true as a matter of law because things have changed in the oil world since the Eleventh Circuit made any statement on that issue. [1518]

But in any event insofar as corn as concerned in the agricultural market, the El Nino effects that were touted in the commercial were not publicly known. Even Mr. Locke will concede, I think, that had a tornado wiped out the corn belt as a result of El Nino and that fact had been published on the screens on the day the market opened on the day that event occurred, it would dramatically have effected the price of corn in the market, and that could not have been an event publicly known at the time of these representations.

And I think that what the commercial demonstrates is that in representations related to El Nino demonstrated is that they were making predictions about what the effects of El Nino were, and they simply were wrong about their predictions.

And so insofar as any allegation in this complaint is related to representations about El Nino and its effects, any such allegation is removed from this complaint by directed verdict.

Any allegation related to the company's failure to disclose its win/loss record to its customers or prospective clients is also removed from the complaint by directed verdict because there is no duty in the law that this Court sees for a commodities futures trading company broker, introducing, full [1519] service, or otherwise that the Court has been able to ascertain to disclose its success with customers either by cherry picking such customers or by taking a total rate of return and submitting it to the public consuming prospective client for consumption and decision.

Further, there is—has been no evidence in this case educed that anyone at R.J. Fitzgerald made any affirmative representation about the success of their customers, specifically or generally, in regard to their prior rate of return, in regard to R.J. Fitzgerald's previous or current success rate with their customers. Therefore, there would

not have been any concomitant counter disclosure required that they had not had such a successful win/loss record.

Further, it has not been established in this record at what point in time R.J. Fitzgerald's win/loss record was at what level; whether it was consistent with the market and other trading houses or whether it was inconsistent with the market and other trading houses.

And so the Court finds there was no obligation, neither in the law or in the facts that establish in this case, to make such disclosure to prospective or existing clients. [1520]

Insofar as failure to provide risk disclosures is concerned as a count of the complaint—which I think encompasses now Mr. Bingham and Mr. Kelley and the Court has removed Mr. Patterson. I find Mr. Patterson's testimony to be patently unbelievable in fact, but that's beside the point.

I think the fact is that no one can determine by a preponderance of the evidence or the evidence presented here that Mr. Patterson did not receive full risk disclosures. Because we simply don't know what he got, nor does he, and nor has the Government established that he didn't get everything.

But insofar as Mr. Bingham and Kelley are concerned, I have to accept the evidence in the light most favorable to the Government. And in the light most favorable to the Government, I think a jury or a fact finder could conclude that they received—that they did not receive risk disclosures. And so I don't think directing a verdict on that issue is appropriate at this stage.

Insofar as controlling person liability is concerned for risk disclosures—and I think that's only against Mr. Fitzgerald or is it against Mr. and Mrs. Fitzgerald?

MS. MANLEY: Just Mr. Fitzgerald. Your [1521] Honor, I just—I'm sorry to interrupt, but Mr. Gonzalez was Mr. Patterson's broker.

THE COURT: I've already ruled.

MS. MANLEY: Okay.

THE COURT: I guess for the same reasons that I have to keep the two people in the case on that issue, I have to keep the controlling person in the case on that issue.

Though, I must say that he is only here because I think I must keep him here because I think that if we're talking about only a balance of a preponderance of the evidence upon his testimony I suppose or testimony of others, the Court might determine that he did not have all things in place that could have been put in place to prevent customers from not receiving risk disclosures before their accounts traded, if the Court finds that that occurs based upon the full consideration of evidence regarding Mr. Bingham and Mr. Kelley.

The Court is going to have to continue to undertake this research about what to do with this in-connection-with argument. I think the cases go both ways on that. I think the cases tend to tilt in favor of the CFTC on that issue by insofar as advertising in general is concerned. [1522]

And I say that in regard to the El Nino commercial, only the El Nino aspects of it are out to the extent that it is projecting unreasonable profits without an alternate disclosure of the potential risks. It still stays in as, perhaps, a misrepresentation in connection with the sale of a security.

And so the Court will just have to undertake to consider what the law really is about whether there has to be proof of an actual transaction or not. Because if there has to be, I think that there's a problem with the case. If there doesn't have to be, then that may not be a problem with the case, and I will undertake it at that time.

Churning has to stay in until the Court can ascertain what the intent of the defendants was, the intent were—I don't know which it is—but in executing the synthetic futures trades for these customers. And I suppose we'll hear a bit about that in the defendants' case.

But right now, I think the evidence is that insofar as Mr. Locke is concerned the trades require a substantial movement in the market, and they were out-of-the-money when made. And that at least as the Government argues satisfies their burden of coming forward with evidence to establish that their purpose [1523] of the trades was to generate cash for the payment of commissions.

And even if it turns out the trades permitted the commissions to be paid, one could argue that if that was its purpose, then that was directly what it wasn't supposed to be—be made for. And so we'll just have to see about the credibility of the defendants' witnesses and evidence on that issue.

Scienter under this fairly low fraud standard that is applicable in the commodities futures business is, in my review of the cases, based on sort of a totality of the circumstances kind of intent.

And I think the Government has proffered some evidence from which the Court could glean scienter as against Mr. Fitzgerald, Mr. Burnett, and Mr. Kowalski. And the Court will have to hear their testimony as it relates to

their scienter or hear their evidence as it relates to scienter to get a sense of whether they intended to defraud people.

I will have to review the testimony eluded to by Ms. Manley as it relates to Mrs. Fitzgerald's knowledge of her obligations with respect to the script and the sales training to determine what she knew and whether it would rise to the level of intent to defraud under the case law. And I will endeavor to do that [1524] before we proceed again on Monday.

And so insofar as there's an outstanding motion on Mr. Locke, the Court will admit his testimony but summarily reject it as not credible on the issue of the efficient market theory, not that the theory doesn't exist but that he has any knowledge or has tested in the way Dalebair (phonetic) requires its applicability in the agricultural market but as irrelevant in any event because of the Court's ruling on the nature of the representations made about El Nino.

Are there any other issues on the directed verdict motion that the Court has not addressed?

MR. GEKAS: Your Honor, I think that Count 1, futures and—let's see—the seminar script, there are other things about the seminar script that I raised.

THE COURT: I think you're going to have to deal with the seminar script in your defense, Mr. Gekas.

MR. GEKAS: Okay.

THE COURT: Insofar as the futures is—the futures count, Count 1, I'm going to review it again. I don't see the evidence of it, but I think it goes to this whole issue of in-connection-with. [1525]

Because if it is sufficient to just raise as generally in an effort to obtain a futures contract or a futures customer and that's sufficient under the law, then the statements were made in connection with the future in relation to a futures contract in an effort to obtain a customer. And we'll just have to undertake to see if that's enough.

Although, I think—Ms. Manley, you can correct me if I'm wrong—your argument is they held themselves out as a futures company, and so they are liable for anything they said about futures contracts; is that right?

MS. MANLEY: Well, Your Honor, that's part of it. The commercials themselves say, We trade futures and options. Mr. Fitzgerald admits that they—these commercials apply to both futures and options.

THE COURT: Does anybody say they ever executed a futures trade?

MS. MANLEY: There have been futures trades, yes, Your Honor. Whether the person saw the commercial and then executed the futures trades, there is no evidence on that, Your Honor.

THE COURT: Who are the customers who entered into futures transactions?

MS. MANLEY: They would be in those monthly [1526] account statements. Future transactions did occur.

THE COURT: But none of the customers that we have specifically talked about—

MS. MANLEY: No, Your Honor.

THE COURT: —and none of the brokers we specifically talked to?

MS. MANLEY: No, Your Honor.

THE COURT: So the Court would have to undertake to go through those boxes to find customers whose accounts were traded in futures?

MS. MANLEY: Yes, Your Honor. Unless you understand that these commercials, these promotional materials applied equally—

THE COURT: Right. Unless we accept the general in-connection-with argument you made?

MS. MANLEY: Yes.

THE COURT: All right. I will undertake to consider that issue when I undertake to determine what to do with this in-connection-with argument.

MR. GEKAS: The other thing, Your Honor, is, first of all, this is pattern and practice of fraud of various regards, and I think we're going to need some guidance as to whether or not that's in the case.

I mean, basically, I think—I made my argument that it's virtually impossible for us to [1527] defend against this. But I don't—I think in the rulings that you've just made, I didn't understand that to be part of the ruling yet.

THE COURT: I don't think it can be, Mr. Gekas. I think the Government has asserted its—its complaint or its proof here. It's set forth its allegations of fraud and the systemic nature of the fraud such as it is. And the defendants are going to have to establish their defense in a way that meets the allegations.

I don't think the allegations are unclear, and I think that if upon consideration of the evidence, the evidence the

Government has submitted, does not outweigh the evidence that you submit in defense of it, then the Government is going to lose on a systemic fraud count.

But I think they have said we made—customers were told that this is what we did. They haven't named those specific customers. And I guess to be fair, the Court can undertake to look more closely at that under the law over the weekend. But I suspect I'm not going to have any clearer an answer for you by Monday than I have now, and maybe that will be an issue for you to reraise at the close of your case.

* *

(2)

No. 04-198

Supreme Court, U.S.
FILED
NOV 15 2004
OFFICE OF THE CLERK

In the Supreme Court of the United States

R.J. FITZGERALD & CO., INC., ET AL., PETITIONERS

v.

COMMODITY FUTURES TRADING COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether an extreme departure from the standards of ordinary care, that presents a danger of misleading customers that is either known to the defendant or so obvious that the defendant must have been aware of it, satisfies the scienter requirement for commodities fraud under 17 C.F.R. 33.10.

2. Whether the court of appeals applied an incorrect standard of appellate review or an incorrect legal standard in determining whether petitioners had a duty to disclose that at least 95% of their customers were losing money.

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In the Supreme Court of the United States

No. 04-198

R.J. FITZGERALD & CO., INC., ET AL., PETITIONERS

v.

COMMODITY FUTURES TRADING COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 3a-44a) is reported at 310 F.3d 1321. The opinion of the district court (Pet. App. 45a-76a) is reported at 173 F. Supp. 2d 1295.

JURISDICTION

The judgment of the court of appeals was entered on October 29, 2002. A petition for rehearing was denied on April 12, 2004 (Pet. App. 1a-2a). On June 29, 2004, Justice Kennedy extended the time within which to file a petition for a writ of certiorari to and including August 10, 2004, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners Raymond Fitzgerald and Leiza Fitzgerald operated petitioner R.J. Fitzgerald & Co. (RJFCO), a commodities brokerage firm "designed specifically to deal with smaller, less experienced customers." Pet. App. 17a n.8. Petitioners attracted such customers in part through a television commercial and a seminar. The commercial, which ran on the cable network CNBC in March 1998, encouraged investors to reap large profits on commodity futures and options on commodity futures based on the weather:

> Investors, El Nino is upon us, and its effect on world crops could mean huge profits in the grain markets. With giant developing nations, such as China and Russia badly in need of grains and world grain supplies put to the test, conditions may exist for profits as high as 200 to 300 percent. * * *
>
> Thus far, El Nino has struck where expected, and if patterns continue, the effects could be devastating. Droughts, floods and other adverse conditions could dramatically alter the supply and demand dynamics of the corn market, but timing is the key. Call R.J. Fitzgerald now for all of the data on this potentially profitable investment.
>
> Option investing involves a high risk of loss and only risk capital should be used.
>
> The potential of the corn market may never be greater. Tight U.S. reserves coupled with domestic and worldwide demand could be the formula for a trade you won't want to miss. Find out how as little as $5,000 could translate into profits as high as 200 to

> 300 percent. Call R.J. Fitzgerald today, 1-800-881-1955.

Gov't C.A. R.E., Tab 5; see Pet. App. 7a-8a.

After the commercial stopped running, the National Futures Association (NFA), an industry self-regulatory organization, informed Raymond Fitzgerald that the commercial was misleading in that it overstated potential returns, gave the impression that weather events were inevitable, and downplayed the risk of loss. Raymond Fitzgerald responded that he had already discontinued the commercial. Pet. App. 8a.

At promotional seminars in 1998, RJFCO told potential customers that whether to invest in futures or options on futures depends on risk tolerance: "If you are highly aggressive and looking for unlimited profit potential as well as unlimited risk than [sic] it would be the futures. But most would like something less aggressive, something offering unlimited profit potential but limited risk—option trade [sic]." Pet. App. 9a-10a (brackets in original).

RJFCO illustrated this "unlimited profit potential" by explaining that over the previous 18 years, there had been an average increase "of 22 cents from the low to the high in the price range" of heating oil. Pet. App. 10a (internal quotation marks omitted). RJFCO represented that an investment of $5000 in a heating oil futures contract would result in $46,200 if there were a "22 cent move" in price. *Ibid.* In contrast, a customer who wanted "limited risk" through an options contract would receive "approximately 50% of that profit—46,200 divided by 2 equals $23,100." *Ibid.* (internal quotation marks omitted). With respect to risk, RJFCO explained that a "'big reason' people lose money is 'greed,' and 'you

will never go broke taking a profit, just take it one piece at a time.'" *Id.* at 10a n.5.

In the course of these solicitations, RJFCO knew but did not disclose that over 95% of its customers were losing money. Pet. App. 19a n.9. Ultimately, the customers lost substantially all of the money they invested in petitioners' schemes. Pet. 4.

2. In 1999, the Commodity Futures Trading Commission (CFTC) commenced this enforcement action pursuant to the Commodities Exchange Act, 7 U.S.C. 1 *et seq.* (CEA or Act). The CFTC alleged, *inter alia*, that petitioners committed fraud by misrepresentation and omission of material facts in connection with the solicitation of commodity futures transactions, in violation of 17 C.F.R. 33.10, which provides:

> It shall be unlawful for any person directly or indirectly:
>
> (a) To cheat or defraud or attempt to cheat or defraud any other person;
>
> * * * * *
>
> (c) To deceive or attempt to deceive any other person by any means whatsoever in or in connection with an offer to enter into, the entry into, the confirmation of the execution of, or the maintenance of, any commodity option transaction.

3. In 2001, a bench trial was held before a magistrate judge. During the trial, the magistrate judge granted a "directed verdict" for petitioners on some of the CFTC's claims, including its claims that petitioners violated the Act by airing the commercial and failing to disclose the firm's loss record to potential customers. At the close of trial, the magistrate judge ruled in petitioners' favor on

the remaining claims, including the claim that petitioners violated the Act by conducting the seminars. Pet. App. 5a-6a.

4. The Eleventh Circuit reversed, and held that the undisputed facts establish fraud as a matter of law. Pet. App. 3a-44a. The court of appeals explained that to establish liability, the CFTC must prove three elements: a misleading statement or omission; materiality; and scienter. *Id.* at 12a. In analyzing these elements, the court was "guided by the principle that the CEA is a remedial statute that serves the crucial purpose of protecting the innocent individual investor—who may know little about the intricacies and complexities of the commodities market—from being misled or deceived." *Id.* at 13a.

The court first explained that "[w]hether a misrepresentation has been made depends on the 'overall message' and the 'common understanding of the information conveyed.'" Pet. App. 12a (quoting *Hammond* v. *Smith Barney, Harris Upham & Co.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,617, at 36,657 & n.12 (Mar. 1, 1990)). Applying that standard, the court concluded that the television commercial aired by petitioners is deceptive as a matter of law because it "overemphasizes profit potential and downplays risk of loss, presenting an unbalanced image of the two." *Id.* at 13a. Specifically, the commercial suggests that "truly enormous profits (200-300%) can be made on options on futures contracts by looking at known and expected weather patterns," and "[a]gainst these highly alluring statements is only boilerplate risk disclosure language." *Id.* at 13a-14a.

The court of appeals held that petitioners' misrepresentations were material because "[i]t is too obvious for

debate that a reasonable listener's choice-making process would be substantially affected by emphatic statements on profit potential ('200-300%') and the suggestion that known and expected weather events are the vehicle for achieving those enormous profits." Pet. App. 15a.

The court followed circuit precedent holding that "scienter is established if Defendant intended to defraud, manipulate, or deceive, or if Defendant's conduct represents an extreme departure from the standards of ordinary care." *Id.* at 12a. The court elaborated:

> [S]cienter is met when Defendant's conduct involves "highly unreasonable omissions or misrepresentations . . . that present a danger of misleading [customers] which is either known to the Defendant or so obvious that Defendant must have been aware of it."

Ibid. (quoting *Ziemba* v. *Cascade Int'l, Inc.*, 256 F.3d 1194, 1202 (11th Cir. 2001)). Under this standard, the court concluded that petitioners acted recklessly in airing the commercial because settled precedents left no doubt that the commercial was deceptive, and "Defendant, as a federally registered professional, knowledgeable in the nuances and complexities of the industry, deviated in an extreme manner from the standards of ordinary care." *Id.* at 15a.

The court of appeals then concluded that the promotional seminar was fraudulent for the foregoing reasons and an additional one: it "suggests that profits on options on futures contracts * * * are proportionately related to the cash market," when in fact they are not. Pet. App. 18a. Finally, the court of appeals held that petitioners fraudulently failed to disclose that more than 95% of the firm's clients lost money in the types of

investments petitioners advertised. Pet. App. 19a. Relying on precedents holding that a "duty to disclose arises where a 'defendant's failure to speak would render the defendant's *own* prior speech misleading or deceptive,'" the court held that "[i]t is misleading and deceptive to speak of 'limited risk' and '200-300' percent profits without also telling the reasonable listener that the overwhelming bulk of firm customers lose money." *Id.* at 19a-20a (quoting *Ziemba*, 256 F.3d at 1206).

Judge Tjoflat wrote a concurring opinion stressing that petitioners "knew that by trumpeting enormous returns and downplaying the risk involved, a reasonable (if unsophisticated) investor would be enticed to make a bet that he would not otherwise make were the full picture disclosed." *Id.* at 26a. The concurrence concluded: "Don't make an active attempt to instill in the investor a grossly inaccurate picture of the risk-to-reward ratio. That is the rule in this case—a rule I find to be abundantly clear." *Ibid.*

Judge Wilson dissented. Pet. App. 26a-44a. Noting that "[n]o customer suffered a loss beyond his or her initial investment," the dissent interpreted the evidence to show that petitioners "did not misrepresent or guarantee profits and in fact disclosed the amount of risk involved." *Id.* at 43a & n.6.

ARGUMENT

Although petitioners contend that the courts of appeals are divided on whether "objective" recklessness satisfies the scienter requirement for commodities and securities fraud, every circuit to address the question has adopted the identical legal standard. In this case, the undisputed facts demonstrate scienter under any plausible standard—petitioners intentionally employed

practices that have repeatedly been recognized to be inherently deceptive, and intentionally withheld information that would have helped to warn their targets of the deception. Petitioners cite no case from any circuit that tolerates such misconduct, and their other assertions of error are based on misstatements of the record. Further review is not warranted.

1. a. There is no conflict regarding the scienter requirement for commodities or securities fraud. The court of appeals held that "scienter is met when Defendant's conduct involves 'highly unreasonable omissions or misrepresentations . . . that present a danger of misleading [customers] which is either known to the Defendant or so obvious that Defendant must have been aware of it.'" Pet. App. 12a (quoting *Ziemba* v. *Cascade Int'l, Inc.*, 256 F.3d 1194, 1202 (11th Cir. 2001)). The court also emphasized that to be reckless, a defendant's conduct must "represent[] an extreme departure from the standards of ordinary care." *Ibid.*

The petition (Pet. 11-17) recognizes that the Second, Sixth, and Seventh Circuits also follow this standard (which petitioners call "objective"), but contends that the District of Columbia, First, Fifth, and Ninth Circuits apply a different standard (which petitioners call "subjective"). Not so. Each of those circuits has expressly adopted the same standard applied here:

D.C. Circuit:

> The kind of recklessness required * * * is an "extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."

SEC v. *Steadman*, 967 F.2d 636, 641-642 (D.C. Cir. 1992) (quoting *Sundstrand Corp.* v. *Sun Chem. Co.*, 553 F.2d 1033, 1045 (7th Cir.), cert. denied, 434 U.S. 875 (1977)).

First Circuit:

> Recklessness is a highly unreasonable omission, involving not merely simple, or even inexcusable[] negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious the actor must have been aware of it.

SEC v. *Fife*, 311 F.3d 1, 9-10 (1st Cir. 2002), cert. denied, 538 U.S. 1031 (2003) (internal quotation marks omitted).

Fifth Circuit:

> Severe recklessness is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it.

Broad v. *Rockwell Int'l Corp.*, 642 F.2d 929, 961-962 (5th Cir.) (en banc), cert. denied, 454 U.S. 965 (1981).

Ninth Circuit:

> [R]eckless conduct may be defined as highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers

> that is either known to the defendant or is so obvious that the actor must have been aware of it.

Hollinger v. *Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc), cert. denied, 499 U.S. 976 (1991) (quoting *Sundstrand*, 553 F.2d at 1045).

Far from disagreeing with other circuits, these four circuits all derived their legal standard from the Seventh Circuit's decision in *Sundstrand*—which, according to the petition (Pet. 14-15), is on the *other* side of the supposed circuit split. See *Fife*, 311 F.3d at 9-10; *Steadman*, 967 F.2d at 641-642; *Hollinger*, 914 F.2d at 1569; *Broad*, 642 F.2d at 961-962. Conversely, the Eleventh Circuit has never disagreed with any of these four circuits, and indeed has favorably cited Fifth and Ninth Circuit cases on this point. See *McDonald* v. *Alan Bush Brokerage Co.*, 863 F.2d 809, 814 & n.10 (11th Cir. 1989); *Messer* v. *E.F. Hutton & Co.*, 847 F.2d 673, 678 (11th Cir. 1988).

b. Instead of reflecting the application of different legal standards, any differences in opinion writing among the cases reflect differences in the types of fraud alleged, and the facts adduced, in each case. In this case, petitioners intentionally made representations that are inherently deceptive. Pet. App. 13a-15a, 17a-19a. The thrust of both the commercial and the seminar was that investors could reap huge profits in reliance on weather patterns and seasonal demand shifts. *Id.* at 14a, 18a. CFTC and judicial precedents have repeatedly held that sales pitches along those lines are inherently deceptive because such facts are already incorporated into the prices of commodities futures. *Id.* at 14a (citing cases); cf. *Basic Inc.* v. *Levinson*, 485 U.S. 224, 246 (1988).

Petitioners compounded their deception by making profit illustrations that falsely assumed that changes in the price of a commodity produce proportional changes in the price of futures and options on futures of the commodity, again in the face of established legal precedent. See Pet. App. 18a. Petitioners even went so far as to hold out the allure of "unlimited profits" with only "limited risk," while failing to mention that 95% of their investors were losing money. *Id.* at 19a. Petitioners thereby engaged in blatant fraud.

On these facts, petitioners' protestations of good faith are unavailing, not because the court of appeals applied an "objective" instead of a "subjective" test, but because the deception was so obvious that petitioners—"federally registered professional[s], knowledgeable in the nuances and complexities of the industry"—must have known what they were doing. Pet. App. 15a; see *id.* at 26a (Tjoflat, J., concurring) ("The defendants in this case *knew* that by trumpeting enormous returns and downplaying the risk involved, a reasonable (if unsophisticated) investor would be enticed to make a bet that he would not otherwise make were the full picture disclosed.") (emphasis added).[1]

The cases cited by petitioners apply the same legal principles to different types of situations. In *CFTC* v. *Savage*, 611 F.2d 270 (1979), the Ninth Circuit explained that the defendant was "accused of prearranging trades that defrauded [a firm's] customers and of entering into offsetting trades with those customers' accounts. Such

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[1] While petitioners contend (Pet. 6) that the court of appeals "did not address the testimonial and circumstantial evidence of subjective good faith," the court specifically addressed petitioners' evidence (Pet. App. 16a) and concluded that it could not overcome the obviousness of the deception here, as established by precedent.

action required that [the defendant] and [the firm] act in concert, concert that would require knowledge on the part of the participants." *Id.* at 283. Thus, the nature of the allegations required that the defendant have actual knowledge not only of his actions and representations (as here), but also that those actions were part of a broader manipulative scheme perpetrated by another.

Even so, the Ninth Circuit did not hold that a fact finder's evaluation of direct evidence of subjective intent is always "*essential*," as the petition suggests (Pet. 11). To the contrary, the court recognized that "[k]nowledge * * * exists when one acts in careless disregard of whether his acts amount to cheating, filing false reports, etc. That is, the element of knowledge cannot be precluded by ignorance brought about by willfully or carelessly ignoring the truth." *Savage*, 611 F.2d at 283. The court simply held, based on the record in that case, that "[w]e cannot say that the facts put forward in the CFTC affidavits raise inferences so reasonable as to defeat [defendant's] claims." *Ibid.*

A similar analysis applies to the D.C. Circuit's decision in *Steadman*, where the defendants, based on a faulty legal opinion, chose not to register under state Blue Sky laws. The SEC filed suit on the theory that the defendants fraudulently failed to disclose the illegality of their non-registration and to book contingent liabilities for penalties that might result from nonregistration. 967 F.2d at 638. Thus, the nature of the allegation required that defendants have actual knowledge not only of their bookkeeping, but also of their potential liability under state law. On the record in that case, the D.C. Circuit held that "the evidence does not permit a finding that [the defendant] actually knew the [legal] opinion was wrong *or was reckless in relying on it*." *Id.* at 642

(emphasis added). Nothing in *Steadman* is inconsistent with the Eleventh Circuit's conclusion that petitioners are liable for intentionally undertaking conduct that is inherently deceptive.

Petitioners also rely (Pet. 7, 12) on a subsequent D.C. Circuit decision, *Saba* v. *Compagnie Nationale Air France*, 78 F.3d 664 (1996), which addressed an airline's liability for damaged baggage under the Warsaw Convention. Even setting to the side the inappositeness of that context, the *Saba dicta* is fully consistent with the decision in this case because it states that "if it can be shown that a defendant gazed upon a specific and obvious danger, a court can infer that the defendant was cognitively aware of the danger and therefore had the requisite subjective intent." *Id.* at 669. The court then held that the danger that cargo wrapped by one company at one place would later be damaged when left outside in the rain by a different company at a different place was not sufficiently obvious. *Id.* at 670. While petitioners are correct that the *Saba* court discussed "subjective" intent, they are wrong to suggest that the D.C. Circuit held that it would never infer such intent from obviousness.

Nor has the First Circuit made such a holding. In *Rodriguez* v. *Montalvo*, 871 F.2d 163, 165 (1989), and *SEC* v. *MacDonald*, 699 F.2d 47, 51 (1983) (en banc), the First Circuit held only that evidence of the defendants' states of mind was relevant, admissible evidence. The First Circuit did not hold that recklessness can never be based on objective facts, notwithstanding a defendant's protestations of subjective good faith. Quite to the contrary, the First Circuit later held that a plaintiff "must demonstrate that the defendants acted with a high degree of recklessness *or* consciously intended to de-

fraud," and ruled in favor of the plaintiff based on objective evidence. *Fife*, 311 F.3d at 9-10 (emphasis added).[2]

The Fifth Circuit cases cited by petitioners (Pet. 13) are even less apposite. In *Southland Securities Corp.* v. *INSpire Insurance Solutions, Inc.*, 365 F.3d 353, 366 (2004), the Fifth Circuit addressed the question whether the scienter of "the individual corporate officer" or "the collective knowledge of all the corporation's officers and employees" is controlling—a question not presented in this case.[3]

The Fifth Circuit's decision in *Broad* v. *Rockwell Int'l Corp.*, *supra*, presented the question whether the issuer of an indenture committed fraud by failing to disclose in a prospectus that under the terms of the indenture, "the right to convert into Collins Common Stock could, in the event of a merger, be replaced with the right to convert into only that which the holders of Collins Common Stock received in the merger." 642 F.2d at 960. Because there was no evidence that the defendants even considered this "boilerplate" provision, which would apply only in "remote future contingencies," the court concluded that the defendants had not acted

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[2] Petitioners' citation (Pet. 13) of *Backman* v. *Polaroid Corp.*, 893 F.2d 1405 (1st Cir.) (withdrawn from bound volume), rev'd on reh'g, 910 F.2d 10, 14 (1st Cir. 1990), is especially unavailing, because the en banc court withdrew the opinion relied on by petitioners long before the First Circuit decided *Fife*.

[3] Petitioners' reliance (Pet. 11 n.3, 13) on *Southland Securities* and *In re Silicon Graphics Inc. Securities Litigation*, 183 F.3d 970 (9th Cir. 1999), is misplaced for an additional reason: those cases applied the *pleading standards* of the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 21D(b)(2), 109 Stat. 747. This is not a private securities fraud case, and it is not at the pleading stage.

recklessly by failing to refer to the provision specifically in the prospectus. *Id.* at 962. In other words, any deception was far from obvious on the facts of that case.

Although petitioners contend (Pet. 13 n.4, 18 n.8) that "the Eighth Circuit standard is unclear" and an intra-circuit split has developed in the Tenth Circuit, petitioners cite no case from either circuit that is in conflict with the decision below. In *SEC* v. *Kluesner*, 834 F.2d 1438 (1987), the Eighth Circuit relied on findings that the defendant did not believe, and "*should not reasonably have believed*," that his representations were misleading. *Id.* at 1439 (emphasis added). In *SEC* v. *Johnston*, No. 90-4189, 1992 WL 180130, at *2 (July 28, 1992)—an unpublished, non-precedential decision—the Tenth Circuit held that summary judgment cannot be predicated on a credibility determination, but did not address whether such a judgment can be predicated on obviousness.[4]

Petitioners are also wrong to contend (Pet. 14) that the CFTC itself disagrees with the legal standard applied by the Eleventh Circuit. The CFTC has long held that conduct is reckless if it "departs so far from the standards of ordinary care that it is very difficult to believe the [actor] was not aware of what he was doing."

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[4] The Third Circuit is also in full agreement with the standard applied by the Eleventh Circuit. See *SEC* v. *Infinity Group Co.*, 212 F.3d 180, 192 (2000), cert. denied, 532 U.S. 905 (2001). The earlier Third Circuit case cited by petitioners (Pet. 15 n.6, 17 n.8), reversed a district court for imposing the burden of proof on the defendant, instead of the plaintiff. *McLean* v. *Alexander*, 599 F.2d 1190, 1196 (1979). The court went on to stress that evidence of the obviousness of a misrepresentation "traditionally supported a finding of liability in the face of repeated assertions of good faith, and continue[s] to do so." *Id.* at 1198.

Do v. *Lind-Waldock & Co.*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,516, at 43,321 (Sept. 27, 1995) (quoting *Drexel Burnham Lambert Inc.* v. *CFTC*, 850 F.2d 742, 748 (D.C. Cir. 1988)); see *Hammond* v. *Smith Barney, Harris Upham & Co.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,617, at 36,659 (Mar. 1, 1990) ("[N]o amount of honest belief * * * can justify baseless, false or reckless misrepresentations or promises.") (quotation marks omitted). Indeed, the CFTC recently cited the decision in this case with approval. *In re First Investors Group of the Palm Beaches, Inc.*, No. 01-10, 2004 WL 1153331, at *7 (May 24, 2004). The earlier decision cited by petitioners remands to an administrative law judge for an evidentiary hearing because the CFTC was not persuaded that summary judgment was proper on the record in that case. See *In re Staryk*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,206 (Dec. 18, 1997).[5]

c. At bottom, petitioners raise a philosophical question: is recklessness actionable because it evidences a subjective state of mind, or is it actionable in and of itself, regardless of any contention of subjective good faith? Petitioners argue (Pet. 11-17) that language from some opinions could be construed to reflect the former

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[5] The Securities and Exchange Commission (SEC) rulemaking cited by petitioners (Pet. 14 n.5) is fully consistent with the authorities cited in the text. The SEC defined recklessness to mean "an 'extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the (actor) or is so obvious that the actor must have been aware of it,'" and determined that subjective good faith is *not* a defense under this standard. *Amendments to Rule 102(e) of the Commission's Rules of Practice*, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,052, at 80,844, 80,851 (Oct. 19, 1998) (quoting *Steadman*, 967 F.2d at 641-642).

rationale, while language from other opinions could be construed to support the latter. But notwithstanding this metaphysical point, the fact remains that all circuits and the CFTC apply the same legal standard. Petitioners cite *no* court of appeals precedent concluding that a defendant who intentionally engaged in obviously deceptive acts lacked the requisite scienter.

This latter point is significant, not only because it shows that this case does not present a circuit conflict, but also because it demonstrates the practical unimportance of any disagreement regarding the philosophical underpinnings of the recklessness test. Under petitioners' view (Pet. 11, 17), the circuits have been divided since at least 1979, when the Ninth Circuit decided *Savage*, supposedly in contravention of *Rolf* v. *Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir.), cert. denied, 439 U.S. 1039 (1978). If any such disagreement were outcome-determinative in any case, surely petitioners could have found one from the past quarter century.

d. The reason petitioners cannot do so is that they are asking for a legal standard that makes little sense as a practical matter. While petitioners assert (Pet. 19) a right to make blatant misrepresentations in "good faith," such "[r]eckless behavior hardly constitutes good faith." *Rolf*, 570 F.2d at 46 n.15; see *Infinity*, 212 F.3d at 193 n.16. Thus, "[t]he civil law generally calls a person reckless who acts * * * in the face of an unjustifiably high risk of harm that is either known *or so obvious that it should be known*." *Farmer* v. *Brennan*, 511 U.S. 825, 836 (1994) (emphasis added).

Nonetheless, petitioners claim (Pet. 10-11) that a trial is required every (or nearly every) time that a defendant claims to have lacked scienter. In addition to being

wasteful and inefficient in cases where the deception was so obvious that the defendant must have been aware of it, this approach would also impose an unrealistic burden of proof. "Proof of a defendant's knowledge or intent will often be inferential * * * and cases thus of necessity [are] cast in terms of recklessness. To require * * * that a factfinder must find a specific intent to deceive or defraud would for all intents and purposes disembowel the * * * cause of action." *Rolf*, 570 F.2d at 47 (citation omitted); see *McLean*, 599 F.2d at 1198. Reliance on the legal standard applied here constitutes "a legitimate substitution for intent to do the proscribed act because, if shown, it is a proxy for that forbidden intent. If it were not used as a proxy, it might be all too easy for the wrongdoer to deliberately blind himself to the consequences of his tortious action." *Saba*, 78 F.3d at 668.

e. At a minimum, the issue petitioners raise does not warrant review at this time. If petitioners are correct, a court of appeals may eventually hold that a broker's subjective good faith relieves him of liability for making inherently deceptive statements, and this Court can consider whether this subtle issue warrants certiorari at that time. If petitioners are not correct, this Court's review will never be required.

It would also be best to consider recklessness for the first time in the context of a securities fraud case. The number of securities fraud cases dwarfs the number of commodities fraud cases. Indeed, almost all of the cases cited by petitioners as the basis for the supposed circuit split are securities cases. While the CFTC has followed securities law precedents in adopting a recklessness standard, see *Hammond*, *supra*, it has also sought to discourage the "uncritical application of security law principles." 40 Fed. Reg. 26,505 (1975). If this Court

were to re-interpret this area of law, a legitimate question would arise whether the securities law standard should continue to apply under 17 C.F.R. 33.10.[6]

2. There is no merit to petitioners' contention (Pet. 20) that the court of appeals departed from decisions of this Court and other courts in holding that petitioners misled their customers.

a. Petitioners contend (Pet. 21) that they had no duty to disclose that at least 95% of their customers were losing money, but they admit that a duty to disclose arises when a defendant makes statements "that would be misleading unless qualified by such a disclosure." That is precisely the reason the court of appeals held that petitioners had a duty to disclose in this case. The court cited authorities for the proposition that a "duty to disclose arises where a 'defendant's failure to speak would render the defendant's *own* prior speech misleading or deceptive,'" and determined:

> Such a disclosure would have gone a long way in balancing out, for example, the affirmative representation in the Commercial that the grain market was ripe for "huge" profits of "200-300 percent" and to telephone RJFCO "now" because such a corn market opportunity may "never" exist again. It would also have done much to counteract the assertion of

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[6] Petitioners are wrong to argue (Pet. 27) that this case presents a good vehicle for considering these issues because the CFTC "expressly waived any claim that the trial court's findings were clearly erroneous" at oral argument before the Eleventh Circuit. CFTC counsel stated that the commission did not challenge the magistrate judge's *credibility* findings, but did not acquiesce in any other findings. Petitioners also overstate the relevance of the magistrate judge's findings. While the magistrate judge found (Pet. App. 59a, 60a, 64a) that petitioners lacked an "intent to mislead," it made no specific findings on recklessness.

> "limited risk" in the Seminar. It is misleading and deceptive to speak of "limited risk" and "200-300" percent profits without also telling the reasonable listener that the overwhelming bulk of firm customers lose money.

Pet. App. 19a-20a (quoting *Ziemba*, 256 F.3d at 1206). Thus, the court did not abandon a nexus requirement, as petitioners contend (Pet. 22). Instead, it explained that petitioners' duty to disclose arose precisely because they made misrepresentations that would have been counteracted by the withheld information.[7]

b. Nor did the court of appeals "contraven[e] the standards for appellate review established by this Court." Pet. 24. The court of appeals stressed that it did not "second guess what the District Court concluded with regard to witness demeanor and credibility," and instead held that the "undisputed facts demonstrate fraud and deception as a matter of law." Pet. App. 13a; see *id.* at 16a-17a.

None of the cases cited by petitioners (Pet. 24) holds that this question cannot be decided as a matter of law. To the contrary, *Silver* v. *H&R Block, Inc.*, 105 F.3d 394, 397 (8th Cir. 1997), affirmed a grant of summary judgment because the statements at issue were not misleading as a matter of law. In *Isquith* v. *Middle South Utilities, Inc.*, 847 F.2d 186, 210-211, cert. denied, 488 U.S. 926 (1988), the Fifth Circuit recognized that it

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[7] Contrary to petitioners' representation (Pet. 21), the CFTC has not conceded that petitioners had no duty to disclose. See Gov't C.A. Reply Br. 24 n.20. Although petitioners also dispute (Pet. 23 n.9) whether 95 percent of their customers lost money during the relevant time period, petitioner Raymond Fitzgerald himself testified to that fact, and the district court found his testimony to be credible. See Gov't C.A. Reply Br. 11-12 & nn.8 & 9 (citing R44-2603, R45-2704).

had "the power to make such an independent evaluation," but chose to remand for the district court to determine in the first instance whether summary judgment was appropriate as a matter of law.[8]

c. Ultimately, the petition boils down to the record-based assertion (Pet. 23) that the Eleventh Circuit "ignored substantial contextual evidence" and "selectively extracted testimony from the record to support its reasoning." In reality, the court considered the contextual evidence of petitioners' deception, including the following facts: (i) petitioners were "federally registered professional[s], knowledgeable in the nuances and complexities of the industry," Pet. App. 15a; (ii) petitioners designed their business "specifically to deal with smaller, less experienced customers," *id.* at 17a n.8; (iii) petitioners employed practices expressly prohibited by settled precedents, *id.* at 16a; and (iv) petitioners knew that more than 95% of their customers were losing money, *id.* at 19a.

The court of appeals also considered and rejected other contextual evidence relied on by petitioners. For example, the court rejected petitioners' reliance on risk disclosures because "a general risk disclosure statement does not automatically preclude liability under the CEA where the overall message is clearly and objectively misleading or deceptive." Pet. App. 14a; see *id.* at 17a n.8. The court also acknowledged petitioners' assertion that some investors had, in the past, made profits as large as 200-300%, but held that "just because such profits are possible, or have happened to some degree in

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[8] *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 450 (1976), which addressed the materiality of an omission, as opposed to the misleading nature of a statement, likewise recognized that summary judgment can be appropriate.

the past, does not mean that the Commercial's total message is not misleading." *Id.* at 17a n.7.[9] Because the Eleventh Circuit applied correct legal principles to the record in this case, further review is not warranted.

3. This case certainly does not present a serious First Amendment issue. While petitioners express concern that the Eleventh Circuit's decision will chill brokers' speech (Pet. 28-29), the very point of the CEA is to deter deceptive speech. The "First Amendment * * * does not prohibit the State from insuring that the stream of commercial information flow[s] cleanly as well as freely." *Virginia State Bd. of Pharmacy* v. *Virginia Citizens Consumer Council, Inc.*, 425 U.S. 748, 771-772 (1976).

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[9] The record does not support petitioners' contention (Pet. 23) that profit illustrations used in the commercials were substantially similar to illustrations used by the Chicago Board of Trade (CBOT) and NFA. Leiza Fitzgerald testified that she created the heating oil illustration on her own, and no one ever testified that the CBOT or the NFA attempted to link increases in *options* prices to winter weather or changes in cash market prices. See Gov't C.A. Reply Br. 20-21 (citing R41-2296, R41-2312).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 04-198

IN THE

Supreme Court of the United States

R.J. FITZGERALD & CO., INC., RAYMOND FITZGERALD, AND LEIZA FITZGERALD,

Petitioners,

v.

COMMODITY FUTURES TRADING COMMISSION,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

REPLY IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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REPLY IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

The CFTC's Brief in Opposition ("Opp.") trivializes the important issues raised in this case. It attempts to deny the existence of a circuit split on whether an objective or subjective standard applies in assessing the existence of scienter for commodities and securities fraud. It then deems the distinction merely "metaphysical." Opp. 17. The CFTC ignores the reality that the Commission's own most recent decision on scienter *contradicts* both the arguments it offers this Court and the majority opinion of the court of appeals. The split of authority is real and significant, and merits resolution by this Court.

Similarly, the CFTC fails to acknowledge the troubling questions raised by the court of appeals' determination that petitioners' speech was misleading. By conducting a *de novo* review of the bare text of the promotions and concluding they were "unbalanced" and misleading as a matter of law, the panel decision introduces serious uncertainty regarding the proper mode of analyzing whether speech is misleading.

Finally, in light of the CFTC's efforts to portray petitioners' promotions as "obviously" misleading, and thus "demonstrat[ing] scienter under any plausible standard," Opp. 7, it bears recalling the basic posture of this case. The decision below finds petitioners guilty of commodities fraud as a matter of law on the basis of speech (1) that was concededly truthful, (2) that they believed was not misleading in good faith and after reasonable inquiry, and (3) that two of the four judges to consider the issue agreed was not misleading.

These circumstances hardly present an "obvious" instance of fraud; in fact, they present a situation in which imposing fraud liability raises serious First Amendment concerns.[1] As

[1] Although there is a substantial government interest in preventing fraud, this Court has also recognized that fraud cases generally impose "[e]xacting proof requirements ... to provide sufficient breathing room

Circuit Judge Wilson's dissent cautioned (Pet. App. 44a):

> Commodities brokerage firms should be on the alert – this decision may make it difficult to advertise and solicit business in the future. It is uncertain what subsequent advertising language may "overemphasize profit and downplay risk of loss."

I. THE COURT SHOULD RESOLVE THE SPLIT AS TO WHETHER SUBJECTIVE CULPABILITY IS NECESSARY FOR COMMODITIES FRAUD

The CFTC commits serious error in its Opposition, blinding itself to a clear circuit split by resorting to strained or superficial treatment of all the key decisions. The CFTC sees an "identical legal standard" among the circuits, Opp. 7, while ignoring the numerous commentators who identify confusion in this supposedly uniform body of law. For example, the leading commodities law treatise states that "the wealth of decisions regarding intent in fraud cases ... offer solace for nearly every possible formulation." 2 Philip Johnson & Thomas Hazen, *Commodities Regulation* § 5.08[1], at 5-91 (3d ed. 2003). *See also* Pet. 9 n. 2.

There is little to the CFTC's superficial observation that cases on both sides of the circuit split refer to the *Sundstrand* language defining recklessness as "an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977). Contrary to the CFTC's suggestion, the petition does not characterize *Sundstrand* as an objective recklessness case. Opp. 10. Rather, it explains that

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for protected speech." *Illinois ex rel. Madigan v. Telemarketing Assocs.*, 538 U.S. 600, 620 (2003).

Sundstrand is ambiguous, lending support to either an objective or subjective formulation, and that ambiguity is a substantial cause of the circuit split. Pet. 14-15. As one commentator has observed, despite "widespread adoption of language from *Sundstrand* ... , *scienter and recklessness are still subject to varying interpretations.*" William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 Hous. L. Rev. 121, 122 (1997) (emphasis added). *Sundstrand* suggests that an obvious danger of misleading customers can support an inference of subjective recklessness, but certainly does not require the position that such an inference is mandatory, or even permissible in the presence of findings that the actor in fact did not appreciate the danger.[2]

Indeed, the First, Fifth, Ninth, and D.C. Circuits and the CFTC itself, while using language paralleling *Sundstrand*, plainly adopt subjective standards that *do* require evidence or inference of the defendant's actual state of mind.

The Ninth Circuit holds that section 4c of the Commodities Exchange Act requires proof "that [defendant's] acts [were] done with knowledge of their nature and character." *CFTC v. Savage*, 611 F.2d 270, 282-83 (9th Cir. 1980) (holding summary judgment improper because "appellant's intent and knowledge are particularly within his personal comprehension"). The CFTC's attempt to distinguish *Savage* confines its discussion to the *wrong* portion of the opinion. *See* Opp. 11-12 (addressing "concert" under § 4b but ignoring that *Savage* applied the same test under § 4c).[3]

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[2] The CFTC is wrong that the trial court "made no specific findings on recklessness." Opp. 19 n.6. The trial court's conclusions of law stated that scienter could be established if a defendant "acted with careless disregard of whether his actions violated the Act," but found "no evidence that Raymond Fitzgerald was aware of any violations and recklessly or intentionally failed to remedy any violations." Pet. App. 66a, 53a.

[3] Tellingly, the Commission itself defines "reckless disregard" under § 4c(b) and Rule 33.10 by quoting the test from *Savage*. *See infra* at 5.

Nor can the majority's decision be reconciled with *SEC v. Steadman*, 967 F.2d 636 (D.C. Cir. 1992). In *Steadman* one defendant was a Harvard Law graduate and all defendants had extensive securities industry experience. The district court found scienter based on objective recklessness, because "it should have been obvious to such people that the advice they received from [their lawyer] was wrong." *Id.* at 642. The D.C. Circuit reversed, holding such obviousness inadequate to establish that any defendant "actually knew the opinion was wrong or was reckless in relying on it." *Id.*

Moreover, the D.C. Circuit later explained that *Steadman* contradicts the very position adopted by the majority below. It "misreads precedent – particularly *Steadman* – ... to conclude that the concept of reckless disregard which meets the subjective standard is satisfied by merely showing an extreme departure from standards of ordinary care." *Saba v. Compagnie Nationale Air France*, 78 F.3d 664, 669 (D.C. Cir. 1996). Here, the majority's analysis asserts only that petitioners "departed in an extreme manner from the ordinary standards of care." Pet. App. 15a, 19a. This approach reduces scienter to "nothing more than gross negligence," *Saba*, 78 F.3d at 669 – contravening this Court's ruling in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

The CFTC's discussion of the other circuits is equally unavailing. It identifies no First or Fifth Circuit case that contradicts the decisions of those circuits defining scienter as "an essentially *subjective* state of mind" that "*must actually exist in the individual* making ... the representation." *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 366 (5th Cir. 2004) (emphasis added); *see also* Pet. 12-13. The CFTC raises *SEC v. Fife*, 311 F.3d 1 (1st Cir. 2002), but mischaracterizes that case as finding scienter based on objective evidence. In *Fife*, defendants agreed not to invest a customer's money without his consent. One defendant claimed he was unaware of the agreement to this effect, but his testimony was contradicted by evidence of a letter

showing that he "was at least aware of some of the Agreement's terms." *Id.* at 10. Based on this evidence of actual knowledge, the First Circuit affirmed the district court's finding of scienter. *Id.*

The Commission's own decision in *Staryk* contradicts the basic premise of the opposition, squarely recognizing the significant difference between an objective and subjective test, and adopting the latter. The Commission affirmed the ALJ's ruling that Staryk's speech was "blatantly false," but "remand[ed] for a hearing on the issue of scienter" because the ALJ erred *as a matter of law*:

> While the deceptive nature of Staryk's solicitations was determined according to an objective standard, his intent in making those representations is a subjective question.

In re Staryk, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,206, 1997 WL 778236, at *4, *7-*10, *12 (CFTC Dec. 18, 1997) ("*Staryk I*"). It held that scienter so depends upon "oral testimony" and "reliably assessing ... credibility" that "Staryk will be prejudiced if his state of mind is determined against him without an opportunity for him to appear in person before a trier of fact." *Id.* at *12.

The CFTC barely discusses *Staryk*, and worse: it fails to disclose its own Summer 2004 decision that elaborates the distinction between the proper subjective test and that applied here by the court of appeals. *In re Staryk*, No. 95-5, 2004 WL 1657544 (CFTC July 23, 2004) ("*Staryk II*").[4] Citing its own prior decisions – including those discussed at Opp. 15-16 – as well as decisions of the Ninth and D.C. Circuits, the Commission defined "reckless disregard" under § 4c and Rule 33.10 as acts "done with knowledge of their nature and character." *Id.* at *9. The Commission validated

[4] This decision was issued a few days before the petition for certiorari was filed in this case, but petitioners did not learn of it until recently. Although *Staryk II* is directly on point, the CFTC did not mention the decision in its opposition despite receiving two extensions to file its brief.

the ALJ's formulation: "credible testimony ... that [Staryk] possessed a good faith belief that he was not misleading customers (no matter how rash he was in its formulation) would preclude a finding of fraud." *Id.* at *5. (And remember, Staryk's speech was already held not just misleading but *blatantly* false.) Although Staryk failed to establish clear error in the ALJ's evaluation of his testimony and demeanor, the Commission criticized the ALJ for characterizing "Staryk's testimony about his personal, educational and employment background, as well as ... firm compliance practices" as "at best tangential" to the issue of scienter. *Id.* at *10 n.22. To the contrary, "[s]ome or all of these factors may lend credence to a respondent's claim of good faith." *Id.* Specifically, Staryk's testimony would have had more weight had he specified which "attorneys and ... compliance officials" had provided advice, "what they told him, or what basis he had for believing their advice to be accurate." *Id.*

It is impossible to reconcile this treatment of scienter with the objective test adopted by the Eleventh, Second, and Sixth Circuits. These courts hold that a defendant's subjective state of mind is irrelevant once objectively reckless conduct is established. *See* Pet. 16-17.

This clear circuit split is no mere "metaphysical" dispute. This Court has recognized the important distinction between objective and subjective tests for *mens rea* in other contexts. *Farmer v. Brennan*, 511 U.S. 825, 836 (1994) (holding that "recklessness is not self-defining" and that an objective test cannot serve as a proxy for intent). Indeed, the Court essentially equated the objective formulation of recklessness advocated here by the CFTC – one based on a risk "so obvious that it should be known," *id.* – with "gross negligence," the very standard rejected by this Court as a basis for securities fraud in *Hochfelder*. It is *not* "quibbling" to debate the meaning of objective versus subjective recklessness. *McGill v. Duckworth*, 944 F.2d 344, 348 (7th Cir. 1991). Indeed, the difference between an objective and subjective test is the

"key divide ... between a means of imposing liability that requires a showing of intent and one that does not." *Saba*, 78 F.3d at 669 (footnote omitted).

This difference is outcome determinative here and in many other cases. Had this case been brought in the Ninth or D.C. Circuit, or before a CFTC ALJ instead of in federal district court, the trial court's judgment of no liability would have been affirmed. Similarly, had this case or *Savage* or *Steadman* been brought in the Second, Sixth, or Eleventh Circuit, fraud liability likely would have been imposed. The distinction is also important in terms of the procedural protections to which a defendant is entitled. In the Eleventh Circuit and other courts applying an objective test, Staryk would not have been entitled to a hearing, and thus – in the Commission's own words – would have been "prejudiced" by having "his state of mind ... determined against him without an opportunity for him to appear in person before a trier of fact." *Staryk I*, 1997 WL 778236, at *12. Petitioners will likewise be prejudiced, absent this Court's intervention.

The CFTC also says that this split of authority should be resolved not here but in a securities case. It offers no basis to believe that the standards are different in the two contexts. *Cf. Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353, 389 n.88, 394 (1982) (explaining that the fraud provisions of the commodities laws are "analogous" to Rule 10b-5). If the standards *are* different, waiting for a securities case of course does nothing to resolve the conflict among commodities fraud cases. Commodities fraud is of unquestionable importance in its own right, and any suggestion to the contrary is a peculiar argument coming from the agency that oversees the nation's commodities markets.

II. THE ELEVENTH CIRCUIT'S ANALYSIS OF WHETHER THE PROMOTIONS WERE MISLEADING REQUIRES REVIEW

The CFTC rewrites then does not respond meaningfully to

the second Question Presented: whether the court of appeals applied an improper standard of review in assessing whether petitioners' speech would mislead a reasonable listener. This issue is not a "record-based assertion" regarding the facts in this case. Opp. 21. Instead, it involves the basic methodology for determining whether speech is misleading. If the opinion below is correct, a trial court faced with an allegedly misleading promotion can spare itself a trial and simply read the text of the promotion. (And an appellate court, in turn, can do the same.) The Court's guidance is warranted in order to instruct lower courts on whether this approach is appropriate.

The petitioners' promotions were not "obviously" misleading, if even misleading at all. Certainly, there was no basis to meet the high threshold established by this Court for resolving such questions against petitioners "as a matter of law." *See, e.g., TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976) (noting that the underlying facts are "merely the starting point" for determining "the inferences a 'reasonable [person]' would draw from a given set of facts"); *see also* Pet. 24. There is no genuine dispute:

- That all the representations at issue were truthful and supported by the firm's actual results. Even a CFTC witness admitted that he turned a $9,000 investment into $27,000 in under four months. R32 at 1477-79 (Judge Scriven noting that "the only evidence we have … establishes that certainly it is possible to [earn profits of 200 to 300 percent] in the commodities market if you bet right").
- That Magistrate Judge Scriven and Circuit Judge Wilson believed these promotions included sufficient risk disclosures and were not misleading. So did the legal compliance department of Iowa Grain (which was independently interested in ensuring compliance given that it was strictly liable for any violations by RJFCO).
- That the commercial contained substantial risk disclosures, as Judge Wilson described at length. Pet. App. 33a-

35a. For example, for 45 seconds a bold message appeared right above the firm's phone number, stating "OPTIONS INVESTING INVOLVES A RISK OF LOSS. MINIMUM ACCOUNT $5,000." Pet. App. 34a. In the middle of the commercial, the voice-over dropped in tone and stated that "option investing involves a high risk of loss and only risk capital should be used." Pet. App. 35a. As Judge Wilson asked, "How much more warning is required than a disclosure that the investment is a '*high risk*'?" Pet. App. 35a.

- That the seminar contained similarly substantial risk disclosures, and its illustrations mirrored those used in publications by industry regulators. Pet. App. 35a-37a. Judge Wilson explained the similarity between RJFCO's statements and those found in the National Futures Association (NFA) manual. Pet. App. 36a.[5] Even a CFTC witness admitted that the risk of loss had been disclosed to her at the seminar, Pet. App. 69a.

- That the promotions claimed almost exactly the *opposite* of what the CFTC asserts, representing truthfully that weather is inherently *un*predictable; that dramatic weather events can give rise to profit opportunities; and that El Niño increased the likelihood that such a dramatic event might occur in the coming months. *See* Pet. App. 78a-79a (holding that "the evidence establishes clearly that no one knew for sure what [El Niño's] effects were going to be in the market"). *See also* Pet. App. 30a-31a (explaining that petitioners focused on market effects of unexpected phe-

[5] Contrary to the CFTC's contention that "the record does not support" this point, Opp. 22 n.9, the trial court made express findings that were not challenged by the CFTC on appeal. Pet. App. 69a; *see also, e.g.*, Br. for Appellees to 11th Cir., tab D at 18 (DX235-18) (NFA illustration showing a $950 call option liquidated for $2,500). The CFTC's own brief cites Mrs. Fitzgerald's testimony that she essentially "plagiarized" the seminar's statements and illustrations from the NFA and CBOT. R41-2296 (cited in Opp. 22 n.9).

nomena, not predictable trends).[6] Judge Wilson clearly explained that these representations are entirely unlike any previously held unlawful. Pet. App. 27a-30a.

- That Petitioners never "misrepresented the firm's track record or lied about successes in the past." Pet. App. 42a-43a. Yet every case cited by the CFTC imposing a duty to disclose a trading record did so based on the nexus between that information and representations about past successes.

In light of the foregoing, it is plain that the Eleventh Circuit could only find petitioners' speech misleading (much less "obviously" misleading) by virtue of a cursory, non-deferential review. The CFTC claims the Eleventh Circuit did consider at least some selected "contextual" evidence, Opp. 21, but does not and cannot claim that the court of appeals properly addressed any of the trial court's factual findings and reversed them as clearly erroneous under Rule 52. Instead, the court of appeals ignored the trial court's findings, and based on the bare text of the promotions, deemed them misleading "as a matter of law." Thus, this Court need not enmesh itself in the facts surrounding the promotions in order to conclude that the court of appeals conducted a superficial and improper *de novo* review in reaching its conclusion that petitioners' speech was misleading.

CONCLUSION

The petition for a writ of certiorari should be granted.

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[6] *See also, e.g.*, Chicago Board of Trade, *Weather and the Corn Market* at 2 (DX119-2) ("It doesn't take a veteran trader to understand that adverse weather, be it frost or too little or too much rain, can seriously tip the balance between supply and demand, creating … significant trading opportunities for the attentive investor.").

Respectfully submitted,

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